No.

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1973

JEROME B. and RUTH B. ROSENTHAL,

Petitioners,

v.

COMMISSIONER, INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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The petitioners, JEROME B. and RUTH B. ROSENTHAL, respectfully pray that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit, entered in this proceeding on November 26, 1973.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit (See Appendix A, infra, pp. A1-A2) has not yet been officially reported or published.

The findings and opinion of the Tax Court are reported at 29 T. C. M. 1521 and at Par. 70, 332 P-H Memo TC (Appendix B, infra, pp. B1-B66).

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit (Appendix A, infra, pp. A1-A2) was entered on November 26, 1973. The jurisdiction of this Court is invoked under 28 U. S. C. §1245(1).

QUESTIONS PRESENTED

1. Whether there is a Constitutional right to a jury trial in a tax liability case.

2. Is the right to trial by jury, as guaranteed by the Seventh Amendment to the

United States Constitution, violated - since confined only to taxpayers who are financially able to and do pay a disputed tax (and then sue for its refund) and denied to taxpayers who are financially unable to first pay the disputed tax?

3. May the Commissioner of Internal Revenue deprive taxpayers of the right to trial by jury, by admittedly arbitrarily substantially increasing the amount of the disputed tax liability by inconsisently treating the same transaction as both valid for computing taxes due, and as invalid for allowing deductions against income, where the result is to prevent taxpayers' payment of tax, suit for refund, and thus deny to taxpayers the jury trial guaranteed by the Seventh Amendment?

4. Is due process, as guaranteed by the Fifth Amendment to the United States Constitution, denied to taxpayers when the Commissioner of Internal Revenue (by Tax Court's quashing subpoenas duces tecum served on Commissioner) is excused from disclosing, revealing or producing documents and evidence, thus preventing taxpayer from proving (a) that, as to the same transaction, not all taxpayers are treated equally or given the same rights, or (b) that some taxpayers are discriminated against, and some are favored, when all taxpayers are situated in exactly the same way, as to exactly the same transaction?

CONSTITUTIONAL & STATUTORY PROVISIONS INVOLVED

Constitution of the United States, Amendment V:

> "No person shall . . . be deprived of life, liberty, or property, without due process of law . . ."

Constitution of the United States, Amendment VII:

> "In suits at common law, where the value in controversy shall exceed $20.00, the right of trial by jury shall be preserved, . . ."

This case also involves Title 26 U.S.C. §163(a) and §7422(a), Title 28 U.S.C. §1346(a)(1), Title 5 U.S.C. §552(c), and United States Tax Court Rules - Rule 44. These are reprinted in pertinent part in Appendix "C", infra, pp. C1-C5.

STATEMENT OF THE CASE

This case arose under the Federal Revenue laws and involves the deductibility of interest payments under I.R.C. §163(a).

On each of the indicated dates, taxpayer (singular refers to both Husband and Wife, taxpayers) entered into a transaction in which he purchased Government Securities (U.S. Bonds and Notes) borrowing funds therefor and pledging the Bonds and Notes as security for the loan.

TRANSACTION NO.	DATE	FACE AMOUNT	BONDS/ NOTES PURCHASED
#1	Feb. 17, 1953	$1,000,000.	Federal Land Bank Bonds
#2	Feb. 26, 1954	100,000.	U.S. Treasury Bonds
#3	Mar. 1, 1954	100,000.	U.S. Treasury Bonds
#4	Dec. 23, 1955	750,000.	U.S. Treasury Notes

The Bonds and Notes which were thus pledged to Gibraltar (the lender) were subsequently sold by Pledgee-Gibraltar without the knowledge or consent of Pledgor-Taxpayer, who further had no control over Gibraltar's actions.

The Commissioner issued Notices of Deficiency for taxable years concerned with all of the four transactions. The basis of the Commissioner's position was that all four transactions were "sham" transactions, to be disregarded for the purpose of disallowing deductions, but that these very same transactions were nevertheless valid for the purposes of taxing income gained therefrom.

This inconsistency by the Commissioner resulted in deficiencies of such exorbitant amounts, that the taxpayer was forced to forego his right to the District Court forum, since payment of the taxes (as thus grossly inflated) could not be made, and thus he had to proceed in the Tax Court, where he was denied the right to a jury trial and to discovery procedures.

In pretrial motions made in 1963 and in 1966, to subpoena Officials of the Internal Revenue in New York and Los Angeles to give testimony for use at trial and to bring certain records with them, pursuant to Rule 44 of the Tax Court Rules, petitioners (taxpayers) requested, and the Tax Court issued subpoenas duces tecum directed to those officials. On motion of the Commissioner, those subpoenas were later quashed by the Tax Court, over the objection of petitioners. Petitioners sought the evidence from those witnesses and subpoenaed documents in order to show that petitioners had been the victim of the arbitrary and capricious discrimination of the Commissioner of Internal Revenue in that

petitioners were denied treatment accorded other similarly situated taxpayers. The quashing of the subpoenas prevented petitioners from presenting material evidence at the trial, to the taxpayers' substantial prejudice.

On November 26, 1973, the United States Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court (Appendix A, infra, pp. A1-A2).

REASONS FOR GRANTING THE WRIT

1. The decision below (Court of Appeals for the Ninth Circuit) directly conflicts with the decision rendered by the Court of Appeals for the Second Circuit and conflicts also in principle with decisions rendered by the Courts of Appeal for the Fifth and Sixth Circuits.

There is a direct conflict between the Ninth Circuit's decision in this case and in Olshausen v. C. I. R., 273 F. 2d 23 (9th Circuit, 1959) and the Second Circuit's decision in Damsky v. Zavatt (2nd Circuit, 1961) 289 F. 2d 46. This conflict centers on the important issue of whether there is a Constitutional right to a jury trial in a tax liability case. The widening spread between the Circuits is further evidenced by the decision rendered in the Fifth Circuit Court

of Appeals in Gefen v. United States (5th Circuit 1969) 409 F. 2d 476, and the decision rendered by the Sixth Circuit Court of Appeals in Farmers'-People's Bank v. United States (6th Circuit 1973) 477 F. 2d 752, which cite and follow that part of the decision in Damsky that held that there was a Constitutional right to a jury trial in a tax liability case.

In Olshausen v. C. I. R., supra, at 27, the Ninth Circuit Court of Appeals stated, "[t]here is no right to a jury trial without paying first as a statutory matter . . . and no right to a jury trial at all in tax matters as a Constitutional requirement. . ." (Citations omitted). However, the Court of Appeals for the Second Circuit in Damsky v. Zavatt, supra, held that an action against Damsky for taxes, penalties and interest for which he was solely liable was a suit at common law within the Seventh Amendment and therefore he was entitled to a jury trial. The Fifth Circuit Court of Appeals in Gefen, supra, at 479, citing and following Damsky, stated "we follow Damsky until the Supreme Court frees us from its validated historical bondage." Further, in what appears to be a plea by the Fifth Circuit Court of Appeals for the Supreme Court to consider the issue, the Court in Gefen, supra, stated at footnote 5, "[e]specially in light of the above authority, we read no commanding language in the Supreme Court opinions to date which would cause us to deviate from the teachings of Damsky."

The Sixth Circuit Court of Appeals, in Farmers'-People's Bank v. United States, supra, at 756, cited and followed Damsky, stating:

> "In Damsky v. Zavatt, 289 F. 2d 46 (2d Circuit, 1961), the Court held in a well-reasoned opinion that an action in personam to recover taxes was one recognized at common law as an action on a debt, a legal cause of action for which a jury trial was appropriate. On the basis of this authority the first prerequisite for a jury trial is met."

The conflicting decisions, in different Circuits, on the issue of a Constitutional right to a jury trial in a tax liability case call for an exercise of this Supreme Court's discretionary review powers to settle this important Constitutional issue.

2. 28 U.S.C.A. §1346(a)(1) and 26 U.S.C.A. §7422 are unconstitutional since they violate the Fifth and Seventh Amendments of the United States Constitution by imposing upon the right to trial by jury in a tax liability case the condition that the taxpayer pay the full amount of the tax assessed before he can get a trial by jury. This means that only those taxpayers who can afford to pay the disputed tax can obtain that which the Constitution guarantees to all citizens, regardless of their wealth, poverty,

or degree of either.

These statutes may give the appearance of granting some sort of choice or right to the taxpayer, but their real effect is to put a restriction or limitation upon that choice, i. e. that the taxpayer be willing and able to pay the disputed tax before a jury trial may be had. The Supreme Court should grant certiorari to review these statutes which limit an important Constitutional right by making it available to only those who can financially afford it, because the maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in United States history and jurisprudence, that any seeming curtailment of the right to a jury trial ought to be scrutinized with utmost care, and such curtailment should be avoided whenever possible.

3. The Constitutional issue presented by petitioners' challenge to the Commissioner's admittedly exaggerated deficiency assessment procedure which can effectively deprive a taxpayer of his right to choice of forum and trial by jury, is also of great and compelling public importance.

The Commissioner's "double-bite" deficiency assessment procedure, i. e. inconsistently treating the very same transaction as valid for producing taxable income but invalid for creating deductions, is an effective means of depriving a taxpayer (who might otherwise be able to pay the actual amount of disputed tax) of his choice between

litigating in the Tax Court or the Federal District Court.

By thus forcing a taxpayer into the Tax Court, the Commissioner deprives the taxpayer of a jury trial and forces him to litigate in a court which is really a part of the Executive (not the Judicial) Branch of government, as is the Internal Revenue Service. See Ginsburg, Is The Tax Court Constitutional? 35 Miss. L. J. 381.

While 28 U. S. C. A. §1346(a)(1) and 26 U. S. C. A. §7422(a) purportedly give taxpayers a choice of paying the deficiency and suing for a refund in the District Court (where a jury trial is available) when these statutes are coupled with the Commissioner's double-bite deficiency assessment procedure, they enable the Commissioner to unilaterally deprive all but the wealthiest taxpayers of that choice by allowing the Commissioner to assert a grossly, arbitrary and artifically inflated deficiency against the taxpayer. Therefore, due process, as guaranteed by the Fifth Amendment, is violated since the fundamental and Constitutionally guaranteed right to a trial by jury (as granted and safeguarded by the Seventh Amendment) is available only to that class of taxpayers who can afford not only to pay the actual amount of taxes actually in dispute, but also who can afford to pay a grossly increased amount, arbitrarily imposed by Commissioner, who admits the increased amount is not the actually disputed amount of taxes.

While it is true that the Commissioner's inflated deficiency assessment is eventually corrected once the Tax Court decides whether the transaction in question was a sham or not, by that time it is too late. The taxpayer has been forced into the Tax Court and deprived of a jury trial and discovery procedures available in the District Court. This situation presents a Constitutional issue of great public importance to all potential tax liability litigants, which should be reviewed by this Court.

4. The issues which the Supreme Court is being called upon to resolve in respect to petitioners' deprivation of trial by jury through the Commissioner's double-bite deficiency assessment procedure and the quashing of petitioners' subpoenas duces tecum by the Tax Court are of great public importance because they concern important questions in the administration and application of Internal Revenue laws.

Petitioner sought, through the subpoenas duces tecum, to show that the Commissioner had allowed interest deductions to other taxpayers who had entered into virtually or actually identical transactions as petitioners did in the instant case. By disallowing petitioners' interest deductions and allowing the same interest deductions to similarly situated taxpayers, the Commissioner treated petitioners in such an arbitrary and capricious manner as to violate petitioners' Fifth Amendment rights of due process.

It was the intent of Congress in creating the Internal Revenue statutes to tax all taxpayers on a uniform basis. U.S. v. Gilmore (1963) 372 U.S. 39, 48, 83 S.Ct. 623, 629, 9 L.Ed. 2d 570; Modern Life and Accident Insurance Co. v. Commissioner of Internal Revenue (7th Cir., 1969) 420 F. 2d 36, 37-38; Staunton Industrial Loan Corp. v. Commissioner of Internal Revenue (4th Cir., 1941) 120 F. 2d 930, 934. Not only is Congressional intent violated by unequal treatment of similarly situated taxpayers by the Internal Revenue Service but so is the Fifth Amendment to the United States Constitution. Recent Supreme Court cases have held that there is an equal protection component in the due process clause of the Fifth Amendment which is applicable to the Federal Government. See especially footnote 5 to U.S. Dept. of Agriculture v. Moreno, 93 S.Ct. 2821 (1973) at 2825, and cases cited therein.

It was not petitioners' intent, by use of the subpoened records and documents, to show that other taxpayers had entered into identical transactions and claimed interest deductions and had not been detected through inadvertence or oversight by the IRS and therefore taxpayer-petitioner should not be disallowed his identical interest deductions. It was rather that other taxpayers, having entered into identical transactions and having had their returns actually reviewed and audited by the IRS, such interest deductions were explicitly allowed by the IRS. Taxpayer-

petitioner should not be deprived of the means to show such arbitrary and unequal treatment of similarly situated taxpayers by the IRS. To allow the quashing of the subpoenas is to perpetuate a government by secrecy, preventing taxpayers from proving that some taxpayers are not equally and uniformly taxed, with all other taxpayers exactly situated, in the same transaction.

In a recent case where the taxpayer sought to show the same sort of arbitrary and unequal treatment of similarly situated taxpayers by the IRS, a Court of Claims Trial Judge granted the taxpayer's motion to examine IRS private rulings, manuals, and surveys and also permitted it to take depositions of IRS officials. Queens-Way To Fashion, Inc. v. U.S., 33 AFTR 2d 74-554, --F.Supp. -- . In Center On Corporate Responsibility, Inc. v. Shultz (DC, DC; 1973) 32 AFTR 2d 73-5297, - F.Supp. --, the Court, in allowing taxpayer to conduct discovery on the IRS to establish arbitrary and unequal treatment concerning their tax exempt status, allowed for deposition, interrogatories and the production of IRS documents and files pertaining to the corporation's application, and all documents in the White House's possession relating to the corporation. These cases and others decided under the Freedom of Information Act (see Tax Analysts & Advocates v. Internal Revenue Service (DC, DC; 1973) 32 AFTR 2d 73-5112, - F.Supp. -; Long v. U.S. Internal Revenue Service (1972) 349 F. Supp. 871) represent the crest of a wave of

anti-secrecy decisions which are having, and will in the future have, a tremendous effect upon the IRS and millions of American taxpayers.

This situation calls for a pronouncement from the Court of Last Resort to delineate the extent to which the IRS can limit or deny the right of all taxpayers to know if they are treated equally. What good is the established democratic policy giving the right to all taxpayers to be treated uniformly, if no taxpayer is allowed access to evidence in the Government's possession by which to determine his fair, equal, and uniform treatment - with all other taxpayers?

CONCLUSION

For the reasons stated above, the decision of the Court of Appeals in the instant case raises questions of general importance in the administration of the tax laws which should be reviewed by this Court. The present petition for certiorari should therefore be granted.

Respectfully submitted,

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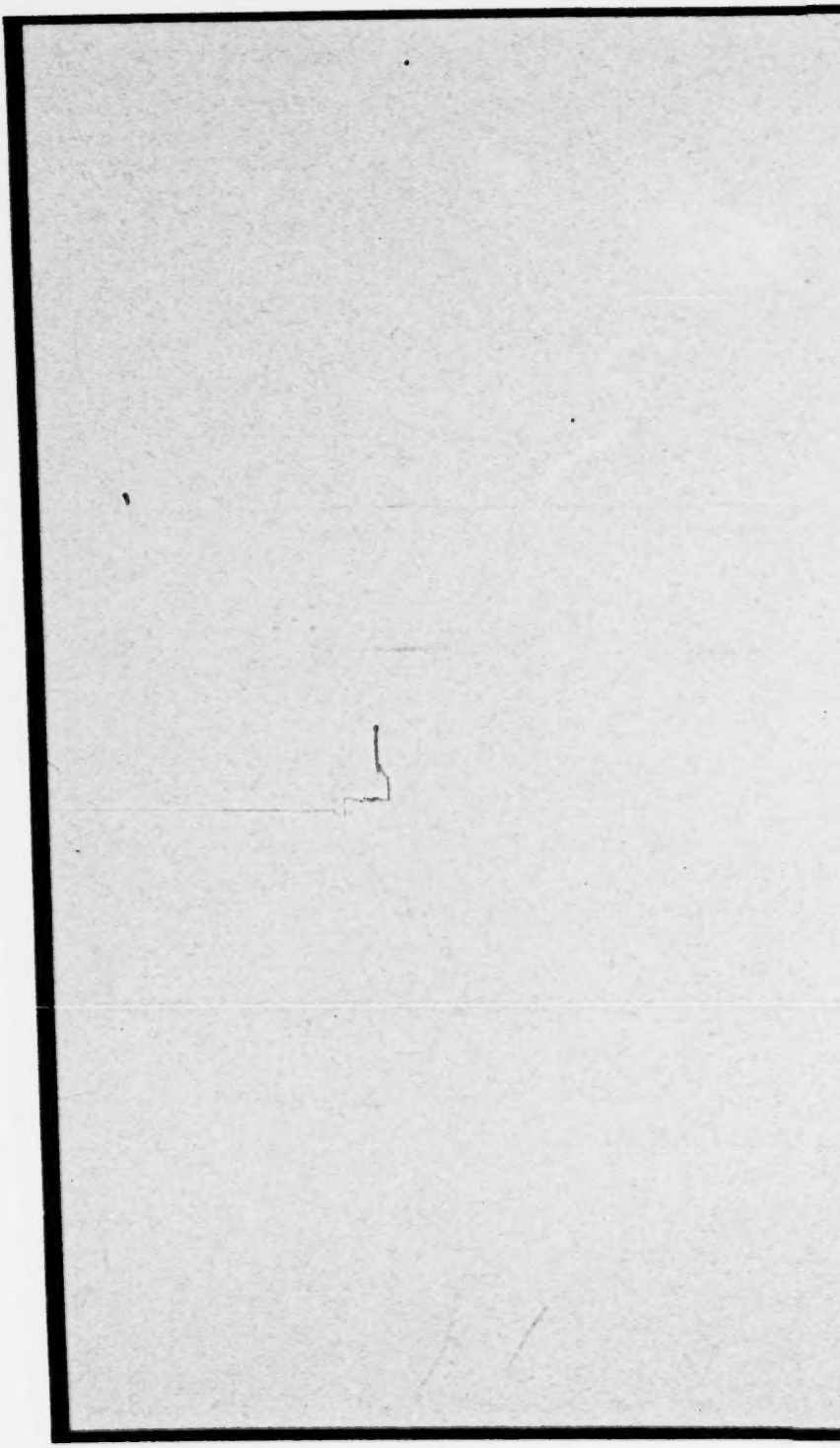

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

JEROME B. ROSENTHAL and RUTH B. ROSENTHAL, *Appellants*, vs. COMMISSIONER OF INTERNAL REVENUE, *Appellee*.	No. 72-1291 MEMORANDUM

[November 26, 1973]

Appeal from Decisions of the Tax Court

Before: CARTER and HUFSTEDLER, Circuit Judges, and JAMESON,* District Judge.

This appeal from decisions of the Tax Court involves deficiencies in federal income taxes for the taxable years 1953, 1955 through 1958, 1960 and 1961.

The Tax Court found that the transactions engaged in by appellants were shams, with no independent commercial substance. The Tax Court held that purported payments of interest on loans obtained to finance the purchase of government securities did not constitute tax deductible "interest . . . on indebtedness" within Sec. 163(a), Internal Revenue Code of 1954, and its predecessor, Sec. 23(b), Internal Revenue Code of 1939. In addition, the Tax Court held that the appellants were not entitled to deduct out-of-pocket expenses incurred in connection with the purported loan transactions, as losses from transactions entered into for profit under Sec. 165, Internal Revenue Code of 1954, or as losses from failure to exercise options under Sect. 1234, Internal Revenue Code of 1954.

The findings and opinion of the Tax Court are reported at 29 T.C.M. 1521.

*Honorable William J. Jameson, Senior United States District Judge, District of Montana, sitting by designation.

Knetsch v. United States, 364 U.S. 361 (1960), is the leading case condemning interest deductions schemes. This court has struck down substantially similar schemes in *Cahn v. Commissioner* (9 Cir. 1966) 358 F.2d 492; *Williams v. Commissioner* (9 Cir. 1963) 323 F.2d 656; *McRae v. Commissioner* (9 Cir. 1961) 294 F.2d 56, *cert. denied*, (1962) 368 U.S. 955; and *Kaye v. Commissioner* (9 Cir. 1961) 287 F.2d 40.

Recently, this court decided adversely to the taxpayer in two cases involving transactions virtually identical to those in our case. *Norton v. Commissioner* (9 Cir. 1973) 474 F.2d 608 and *Melcher v. Commissioner* (9 Cir. 1973) 476 F.2d 398.

The findings of the Tax Court are amply supported by the evidence and its decisions are correct.

Appellants' constitutional contentions are without merit and were not raised below.

At argument, appellants' main contentions involved alleged error by the Tax Court in quashing subpoenas duces tecum.

The subpoenas duces tecum were quashed by the Tax Court in 1963 and 1966. The subpoenas broadly requested every document, record, directive and inter-office memorandum in Internal Revenue files relating to *all* taxpayers who ever paid interest to a lender secured by United States Government securities and whose interest deductions were questioned by the Internal Revenue Service. The proposed use of such material was to show unequal treatment accorded to appellants.

The subpoenas were too broad. But also, their proposed use raises serious problems. The appellants proposed to use files of other taxpayers to absolve themselves of a liability for improper deduction of interest. In doing so they would invade the privacy which the other taxpayers would expect to attach to their income tax returns.

In contradiction to appellants' naked allegations of discrimination are the many cases disallowing deductions of interest in transactions similar to that of appellants. They demonstrate uniform treatment by the Commissioner.

Affirmed.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO 11-30-73—480

APPENDIX B

T. C. Memo. 1970-332

UNITED STATES TAX COURT

JEROME B. ROSENTHAL AND RUTH ROSENTHAL, Petitioners[1] v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 67848, 77923, 77924, 77925, 93832, 1986-62, 1392-64, 1393-64

Filed November 30, 1970.

Issue 1: Government Bonds Transactions. (a) Held, upon the facts: That in each one of the four transactions involving $1,000,000 Federal Land Bank bonds, $100,000 U. S. Treasury bonds, $100,000 Treasury bonds, and $750,000 Treasury notes, respectively, the petitioner, Jerome B. Rosenthal, did not enter into a bona fide transaction in each

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[1] The cases consolidated with Docket No. 67848, Jerome B. Rosenthal and Ruth Rosenthal (1953) are: Docket No. 77923, Ruth Rosenthal (1955); Docket No. 77925, Jerome B. Rosenthal (1955); Docket No. 77924, Jerome B. Rosenthal and Ruth B. Rosenthal (1956); Docket No. 93832, Jerome B. Rosenthal and Ruth B. Rosenthal (1957); Docket No. 1986-62, Jerome B. Rosenthal and Ruth Rosenthal (1958); Docket No. 1392-64, Ruth B. Rosenthal (1960, 1961); Docket No. 1393-64, Jerome B. Rosenthal (1960, 1961).

instance on February 17, 1953, February 26, 1954, March 1, 1954, and December 23, 1955, respectively, for the purchase of the securities which purportedly were involved; that each transaction was without substance and reality and was a sham transaction; that none of the transactions can be recognized for tax purposes; that in reality petitioner did not purchase the securities referred to in each transaction; that petitioner did not borrow and was not indebted for, in the respective transactions, $1,052,000, $105,000, $105,000, $712,500 (note to Gibraltar), and $37,500 (note to CHK); and that the amounts paid by petitioner during the years involved in each transaction, pursuant to his several "notes," were not interest paid on indebtedness and, therefore, the payments were not deductible under section 23(b), 1939 Code, and section 163(a), 1954 Code.

(b) Held: That since each transaction was a sham, there shall be excluded from taxable income, under Rule 50, for the taxable years before the Court, the respective amounts included in income as "interest received" on the Government securities, and the so-called "capital gains" from the purported sales of the securities.

(c) Held, upon the facts: That, in the alternative, deductions are not allowable for petitioner's out-of-pocket costs as losses from transactions entered into for profit under section 117(g)(2), or as losses from failures to exercise options under section 1234, 1954 Code.

Issue 2: Income in 1953 from B R N M Law Partnership.

Held, upon the facts: That Rosenthal

did not realize unreported income in 1953 from the B R N M Law partnership in the amount of $4,134.81, and that his share thereof did not exceed $25,222.29; respondent's determinations were incorrect.

Issue 3: Deductions for Legal Expenses. Held: That deductions are not allowable under section 212 for legal fees and costs paid in 1960 and 1961; held, further, that the expenditures were personal expenses of Jerome B. Rosenthal and are not deductible under Section 262.

Issue 4: Docket Nos. 77923, 77925, Increased Deficiencies for 1955. Held: That the assessment and collection of increases in the deficiencies for 1955, claimed by the respondent, are not barred by the statute of limitations, section 6214(a).

Jerome B. Rosenthal, pro se.*

Eli Blumenfeld and Myron Weiss, for the respondent.

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*Morton Rosen and Robert Forst appeared in the trial and on the briefs in these cases, but recently withdrew as counsel. The petitioner, Jerome B. Rosenthal, is the sole remaining counsel in these cases.

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MEMORANDUM FINDINGS OF FACT AND OPINION

HARRON, Judge: Respondent determined deficiencies in income taxes in the total amount of $122,896.84 for the years of 1953, 1955-1958, 1960, and 1961; (the years 1954 and 1959 are not before the Court). For 1955, in his amended pleading (the amended answers), he made a determination denying a deduction of $7,723.67 claimed as an interest deduction, and he made claims for increased deficiencies under section 6214(a). For 1960, with respect to the separate return in the name of Ruth Rosenthal, he determined a 25 percent penalty, an addition to tax, of $866.38 under section 6651(a). The determinations are as follows (J. R. refers to the petitioner, Jerome B. Rosenthal, and R. R. refers to Ruth Rosenthal):

Year	Docket No.		Deficiency	Section 6651(a)
1953	67848		$26,385.43	
1955	77923	R. R.	17,434.80	
		Increase	2,780.52	
	77925	J. R.	17,302.80	
		Increase	2,780.52	
1956	77924		21,795.89	
1957	93832		18,527.07	
1958	1986-62		3,759.04	
1960	1392-64	R. R.	3,309.57	$866.38
	1393-64	J. R.	3,273.58	

Year	Docket No.	Deficiency	Section 6651(a)
1961	1392-64 R. R.	2,782.80	
	1393-64 J. R.	2,764.82	
		$122,896.84	$866.38

The taxable years 1954 and 1959 are not before the Court.

The issues are:

1. Whether there was a real and bona fide indebtedness owed by the petitioner, Jerome B. Rosenthal, in each one of four transactions involving Government bonds; or whether each transaction lacked substance or was a sham, so that payments in each of the taxable years were not interest on indebtedness within the meaning of section 23(b), 1939 Code, and section 163(a), 1954 Code. The petitioner made payments, ostensibly as interest, in the taxable years in the following total amounts, for which he took deductions, which were disallowed by respondent:

Year	Sum Paid and Deducted as Interest
1953	$39,111.01
1955	63,464.62
1956	34,921.41
1957	36,063.61
1958	19,689.77
1960	5,625.00
Total	$198,875.42

Because separate returns were filed for 1955 and 1960, deductions of one-half of the payments made in eachof those years were deducted on the returns of the petitioner, Ruth B. Rosenthal.

Whether, in the alternative, deductions are allowable for the cost or net out-of-pocket expense, if any, spent in connection with each transaction (a) as losses from transactions entered into for profit, under section 23(e)(2), 1939 Code, or section 117(g)(2), 1954 Code; or (b) as losses resulting from the failure to exercise privileges or options to buy or sell property, under section 165(c), 1939 Code, or section 1234, 1954 Code.

2. Whether Rosenthal's income for 1953 from a former law partnership was more than $25,222.29, as reported in his return.

3. Whether deductions for 1960 and 1961 are allowable under section 212 for legal fees and costs paid in connection with the divorce in 1964 of the petitioners.

4. Whether respondent's claim for increased deficiencies for 1955 is barred by the statute of limitations.

In Docket No. 1392-64, the respondent has conceded that there should not be a 25 percent addition to the tax for 1960 under section 6651(a).

Recomputations of the amounts of the deficiencies for all or some of the taxable years, under Rule 50, are required.

ULTIMATE FINDINGS OF FACT

Issue 1: Transactions in Government Securities

1. Claimed "Interest" Deductions: The following findings relate to each one of the four purported transactions in Government securities.

Each transaction was a paper transaction, and was a sham. In each transaction: No securities were purchased by or for Rosenthal or for his account, except for a day or so because if and when securities were ordered from a dealer, they were delivered to Irving for redelivery to a dealer to whom they were sold in an "In" and "Out" procedure almost immediately; none was held for his account; and no actual bond or note interest on any of the securities purportedly involved was received by Gibraltar or Rosenthal. The closing of Rosenthal's four accounts on Gibraltar's books consisted only of bookkeeping entries; they did not reflect any bona fide sale at the end of any securities which had been "held" for his account under a "pledge" with Gibraltar. No securities were "pledged" with Gibraltar in spite of such statement in the promissory notes of Rosenthal. There were no bona fide and real "short sales" by Gibraltar of any securities "held" for Rosenthal and "pledged" with Gibraltar. The transactions of Cantor-Fitzgerald and of Gibraltar with securities dealers Faroll, Childs, Devine, and Ehlenberger involved sales of securities on or close to the same dates when the same securities had been purchased from a dealer, and they closed each transaction in an "In and Out" procedure almost immediately thereby canceling each purchase and providing the funds

with which to pay for each purchase. The transactions were not in reality or in fact "short sales" of securities bought and paid for, and held for Rosenthal. Each "In and Out" transaction through Irving, with dealers, was handled in such way that money was not borrowed by Gibraltar, or by Rosenthal, and no real and bona fide indebtedness was incurred by or for Rosenthal. The securities disposed of to nullify purchases at about the same time, through Irving Trust, were not replaced by Gibraltar. Each "In and Out" procedure involving the temporary delivery and redelivery by Irving Trust of Government securities was no more than a paper device which utilized the routine procedures of clearance agents for the purpose of providing brokers' confirmation slips which would give the appearance of a "purchase" of securities, and the appearance of a long term indebtedness which, in fact, did not come into existence.

Each promissory note executed by Rosenthal, payable to Gibraltar and, in one instance to CHK, was merely a part of a subterfuge and paper transaction; and the promissory notes merely provided the basis for the respective entries on Gibraltar's books, and the appearance of purported "indebtedness" and "interest" payments. None of the promissory notes was evidence of actual indebtedness or of any obligation to make payments for the use of borrowed money. The payments described on each note as "interest" were not in fact and substance interest on indebtedness.

With respect to each note of petitioner, payable to Gibraltar, none was secured, and no securities were in fact "pledged" with Gibraltar. It was not the intention of the petitioner or Gibraltar that petitioner would

or could obtain any "return" of the described securities by paying Gibraltar the stated principal amount of the note. The provision in each note that it was secured by "pledged" securities merely provided a basis for the appearance of collections by Gibraltar of coupon interest on such purportedly "pledged" securities, whereas, in fact, no coupon interest was received by Gibraltar, or "owed" by Gibraltar to petitioner.

Each account in petitioner's name on Gibraltar's books was a paper account, and in each instance there was not an actual and bona fide indebtedness of petitioner to Gibraltar for a loan of funds or a bona fide purchase of Government securities for his account. The book entries in each account were part of a paper transaction which was lacking in substance.

Although petitioner made payments to Gibraltar, as specified in each promissory note, and in the stated amounts, Gibraltar in fact refunded to petitioner a substantial part of each payment (or all of it in some instances) under the guise of payments of a "reserve" fund or of coupon interest on purportedly "pledged" securities. The prescribed payments to Gibraltar of "interest" were part of each sham and paper transaction, and they merely provided the appearance for tax deductions in stated amounts.

Petitioner's out-of-pocket expense in transactions 1, 2, and 3 constituted his payment of a charge and fee by Gibraltar for providing a facade for claiming tax deductions. Petitioner's expenses were $9,322.88, $3,669.47, and $3,794.38, respectively, in the first 3 transactions. In transaction 4,

petitioner actually received from Gibraltar, in 1956, a cash payment in the net amount of $1,428.34, which represented taxable income for 1960, the end of the transaction.

In transactions 1, 2, and 3, the so-called "reserve" referred to in each original promissory note of petitioner, $90,388.90, $17,359.46, and $17,211.67, respectively, was not in fact a reserve by Gibraltar of its own funds, and Gibraltar did not pay any of those amounts from its own funds. Instead, the payments by Gibraltar to petitioner, in the guise of payments out of a "reserve" fund, were in fact refunds to petitioner of a substantial part of his payments of so-called "interest" on each note.

The closing of each one of the 4 transactions did not involve any actual or bona fide sale of securities for petitioner's account, and no funds were in fact received by Gibraltar from such purported, closing sales. Each transaction was closed merely by a bookkeeping credit to petitioner's account which was part of each sham transaction.

Gibraltar did not have sufficient cash on hand with which to loan petitioner the principal amount stated on each promissory note of petitioner, on or about the date of each note, or at any material date. Gibraltar did not borrow and then loan to petitioner the principal amount of each note in any of the transactions.

Gibraltar did not in fact receive any coupon interest on any Government securities, in each transaction. Credits to the principal amount of a promissory note of petitioner, in the instances where such credits were entered on Gibraltar's books, were merely gratuitous reductions in the principal amount

of the note by Gibraltar, and were merely bookkeeping entries, and were part of the sham transaction. In other instances, Gibraltar's cash payments to petitioner of purported coupon interest on Government securities, purportedly "pledged," were in fact refunds to petitioner of all or a substantial part of his payments to Gibraltar of purported note "interest."

In transaction 4, CHK was merely a conduit through which Gibraltar transferred $37,500 to petitioner, and $37,500 was not loaned to petitioner by either CHK or Gibraltar. Petitioner's promissory note to CHK for $37,500 was not evidence of an indebtedness of petitioner, or of a loan to him. In fact, the transfer of $37,500 in cash to petitioner, through CHK, on December 23, 1955, represented the following: a refund to petitioner by Gibraltar of the first payment of so-called "interest," on petitioner's promissory note, in the amount of $25,301.11; a refund to petitioner of $5,598.11 which he paid to Faroll on the same date; and a refund of most of the so-called prepayment of "interest" to CHK on petitioner's note to CHK, of $7,723.67. All of petitioner's expenditures on December 23, 1955, above, totaling $38,622.89, were refunded to petitioner by Gibraltar through the payment by CHK of $37,500 and through Gibraltar's payment of "interest" on Treasury notes of $5,625 on March 31, 1956. If "refund" to petitioner is not precisely accurate, then in this financial round robin, petitioner immediately repaid the $37,500 to Gibraltar on December 23, 1955, directly and for Gibraltar's benefit. No loan was made to petitioner of that fund. No interest on indebtedness or for the use of money was paid to CHK by petitioner. Petitioner's payment of $7,723.67 to CHK was not a

payment of interest on indebtedness. There was no bona fide indebtedness of $37,500 owing by petitioner to CHK or Gibraltar.

Petitioner failed to prove, in rebuttal, that the $7,723.67 was retained by CHK and was not paid to Gibraltar. Since Gibraltar advanced funds to CHK, which included the $37,500, the reasonable inference is that CHK paid the $7,723.67 to Gibraltar. The finding is made that CHK did so, in the absence of contrary evidence; there is no evidence establishing a reasonable basis for concluding that CHK retained the $7,723.67, and a finding to that effect cannot be made.

Each transaction, 1, 2, 3, and 4, was lacking in any real and substantive economic benefit to petitioner apart from anticipated tax benefits. In Transaction 4, the arithmetic "net economic gain" of $1,428.34 was not a true economic gain but was merely a credit balance in petitioner's favor (which Gibraltar paid to petitioner) arising from Gibraltar's cash payments to him in the guise of coupon interest on Treasury notes.

The bookkeeping balance of $37,500 in petitioner's favor at the end of Transaction 4, on April 1, 1960, was not a bona fide balance owing to petitioner. Rather, it represented Gibraltar's bookkeeping "reserve" and was no more than an integral part of the paper transaction. It was an anticipated balance based upon a "charge" to petitioner under his note of only $712,500, as petitioner's note to Gibraltar did not include the $37,500 "reserve," and "redemption" of the "pledged" notes for $750,000 was anticipated. Gibraltar's payment of $37,500 to petitioner reflected, in fact, a credit to be applied to the account

of CHK which received the $37,500 from petitioner and paid it back to Gibraltar in another round robin.

The principal purpose of each transaction, including CHK, was the creation of a facade for claiming tax deductions. Apart from tax purposes, each transaction was devoid of substance and commercial reality, and did not involve any real indebtedness within the meaning of section 23(b), 1939 Code, and section 163(a), 1954 Code. In each transaction, petitioner did not pay any interest on indebtedness to Gibraltar, and none was paid to CHK in Transaction 4. As a transaction for the purchase of securities, each one of the four transactions was a sham. Since each transaction was a sham, not recognizable for tax purposes, petitioner did not realize any taxable income therefrom, except $1,428.34, explained below, and his payments were not interest on indebtedness.

Each transaction was lacking in economic benefit to petitioner, apart from hoped-for tax benefits. The principal purpose of each transaction was not to realize a profit but was to provide a basis for tax deductions.

Petitioner realized taxable income under Transaction 4, even though it was a sham, from Gibraltar's cash payment to him in the net amount of $1,428.34, out of $5,625 on April 1, 1956, because that net amount of $1,428.34 was in excess of petitioner's payments to Gibraltar and of Gibraltar's credits to him as of the end of the transaction of April 1, 1960. The $1,428.34 was income to petitioner in 1960 because it was paid to him out of Gibraltar's funds, it was not a gift, and as of April 1, 1960, it was

established by the bookkeeping entries that Gibraltar had paid that amount to petitioner from its own funds.

The steps on December 23, 1955, whereby petitioner received $37,500 and gave his promissory note to CHK in that amount were an integral part of transaction 4 with Gibraltar, and those steps followed by CHK did not constitute a separate transaction between petitioner and CHK. In substance and reality, CHK did not "borrow" $37,500 from Gibraltar to "loan" to petitioner, and there was not a bona fide indebtedness for $37,500 owing by petitioner to CHK or by CHK to Gibraltar. Rather CHK was merely a conduit through which Gibraltar transferred $37,500 to petitioner on December 23, 1955. Since Gibraltar, on the same date, received back, directly or indirectly, $38,622.89 (which included the $37,500) there was a round-robin of this fund as between petitioner and Gibraltar which represented either an immediate repayment by petitioner, or Gibraltar's refund to him for his expenditures to or on behalf of Gibraltar. No bona fide indebtedness owing by petitioner to CHK or Gibraltar resulted from this monetary round-robin, and petitioner's promissory note to CHK was not evidence of any indebtedness due from him.

OPINION

Issue 1: Four Transactions in Government Securities: Deductions for Payments of Alleged Interest; or, in the alternative, for Loss.

A. Deductions Claimed as Interest:

The main question under this issue is whether there was in each one of the four transactions in Government securities a bona fide and real indebtedness of Rosenthal to Gibraltar, and also to CHK Company in Transaction 4, evidenced by promissory notes, so that the payments made by Rosenthal pursuant to the notes during the taxable years as "interest" on the purported "loans" constituted interest paid on indebtedness within the meaning of section 23(b), 1939 Code, and section 163(a), 1954 Code. [2]

Prior to the trial of these cases the respondent, in his amended answers in Docket Nos. 77923 and 77925, made claims for increases in the deficiencies for 1955 on the ground that deductions taken in the tax returns for 1955 totaling $7,723.67, for payments to CHK Company, were not payments of interest on indebtedness. Respondent had the burden of proof with respect to the issue pleaded in his amended answers. Rule 32, Rules of Practice of this Court.

2
SEC. 23. DEDUCTIONS FROM GROSS INCOME. [1939 Code]

* * * * *

(b) INTEREST.--All interest paid or accrued within the taxable year on indebtedness. * * *

SEC. 163. INTEREST. [1954 Code]

(a) GENERAL RULE--There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

In the statutory notices of deficiencies for all of the taxable years, respondent disallowed all of the deductions taken for the payments to Gibraltar pursuant to petitioner's promissory notes. Respondent determined that the payments were not payments of interest on indebtedness within the meaning of sections 23(b), 1939 Code, and 163(a), 1954 Code. He determined further that deductions for those payments were not allowable under any Code provision.

With respect to the main question which results from respondent's determinations in the deficiency notices, the petitioner had the burden of proof. Rule 32, Rules of Practice of this Court; and Max Barnett, 44 T.C. 261, 276 (1965), affd. 364 F.2d 742 (C.A. 2, 1966). Petitioner has presented arguments to the effect that his burden of proof is a limited one. Consideration has been given to those contentions. Our conclusion is that petitioner had the burden of proof in general and with respect to all of the questions involved under the main issue, except with respect to the new question pleaded by respondent in his amended answers, as set forth above.

Additional questions are in issue resulting from petitioner's alternative contention that if it is held that the payments made pursuant to his notes were not interest on indebtedness, then his out-of-pocket expenses are deductible as a loss under either section 117(g)(2), or section 1234. The questions resulting from the alternative contentions are set forth hereinafter.

It is an established rule of law that "interest on indebtedness," as used in the statute, means "compensation for the use or

forbearance of money," Deputy v. Du Pont, 308 U.S. 488, 498 (1939). It has been defined, also, as "the amount which one has contracted to pay for the use of borrowed money." Old Colony R. R. Co. v. Commissioner, 284 U.S. 552, 560 (1932). The term "indebtedness," as used in the statute, has been defined as "an unconditional and legally enforceable obligation for the payment of money." Autenreith v. Commissioner, 115 F.2d 856, 858 (C.A. 3, 1940); Commissioner v. Park, 113 F.2d 352, 354 (C.A. 3, 1940); Gilman v. Commissioner, 53 F.2d 47, 50 (C.A. 8, 1931).

Upon due consideration of all of the evidence, our conclusion and findings are that Rosenthal did not "contract to pay for the use or forbearance of money." The use of money was never a right of Rosenthal in all of the transactions and arrangements, and no loans were made to him. The elaborate transactions can best be described as shams within the rule of Goodstein v. Commissioner, 267 F.2d 127 (C.A. 1, 1959), affirming 30 T.C. 1178; Lynch v. Commissioner, 273 F.2d 867 (C.A. 2, 1959), affirming 31 T.C. 990; Knetsch v. United States, 364 U.S. 361 (1960).

These cases, on their facts, are indistinguishable in principle from the substantial number of cases which have held that payments of purported "interest" on alleged "loans" were not interest on indebtedness and, therefore, were not deductible. Knetsch v. United States, supra; Sammy Cahn, 41 T.C. 858 (1964), affd. 358 F.2d 492 (C.A. 9, 1966); Williams v. Commissioner, 323 F.2d 656 (C.A. 9, 1963), affirming a Memorandum Opinion of this Court; Amor F. Pierce, 37 T.C. 1039 (1962), affd. 311 F.2d 894 (C.A. 9, 1962); Danny Kaye, 33 T.C. 511 (1959),

affd. 287 F. 2d 40 (C. A. 9, 1961); Gordon MacRae, 34 T. C. 20 (1960), remanded on another issue, 294 F. 2d 56 (C. A. 9, 1961), certiorari denied 368 U. S. 955; Goodstein v. Commissioner, supra; Sonnabend v. Commissioner, 267 F. 2d 319 (C. A. 1, 1959), affirming a Memorandum Opinion of this Court; Lifschultz v. Commissioner, 393 F. 2d 232 (C. A. 2, 1968), affirming a Memorandum Opinion of this Court; Benenson v. United States, 385 F. 2d 26 (C. A. 2, 1967); Max Barnett, supra, 44 T. C. 261 (1965), affd. 364 F. 2d 742 (C. A. 2, 1966), certiorari denied 385 U. S. 1005; Kapel Goldstein, 44 T. C. 284, affd. 364 F. 2d 734; Minchin v. Commissioner, 335 F. 2d 30 (C. A. 2, 1964), affirming a Memorandum Opinion of this Court; Jockmus v. United States, 335 F. 2d 23 (C. A. 2, 1964); Becker v. Commissioner, 277 F. 2d 146 (C. A. 2, 1960), modifying a Memorandum Opinion of this Court; Lynch v. Commissioner, supra; Leslie Julian, 31 T. C. 998 (1959), affd. 273 F. 2d 867 (C. A. 2, 1959); Carl E. Weller, 31 T. C. 33 (1958), affd. 270 F. 2d 294 (C. A. 3, 1959), certiorari denied 364 U. S. 908; W. Stuart Emmons, 31 T. C. 26 (1958), affd. 270 F. 2d 294 (C. A. 3, 1959); Joseph H. Bridges, 39 T. C. 1064 (1963), affd. 325 F. 2d 180 (C. A. 4, 1963); Perry A. Nichols, 37 T. C. 772 (1962), affd. 314 F. 2d 337 (C. A. 5, 1963); United States v. Roderick, 290 F. 2d 823 (C. A. 5, 1961); Gheen v. Commissioner, 331 F. 2d 470 (C. A. 6, 1964), affirming a Memorandum Opinion of this Court; Knowles Electronics, Inc. v. United States, 365 F. 2d 43 (C. A. 7, 1966); Lewis v. Commissioner, 328 F. 2d 634 (C. A. 7, 1964), affirming a Memorandum Opinion of this Court, certiorari denied 379 U. S. 821; Dooley v. Commissioner, 332 F. 2d 463 (C. A. 7, 1964), affirming a Memorandum Opinion of this Court, certiorari denied 379

U.S. 821; Dooley v. Commissioner, 332 F. 2d 463 (C. A. 7, 1964), affirming a Memorandum Opinion of this Court; Rubin v. United States, 304 F. 2d 766 *C. A. 7, 1962); Rothschild v. United States, 407 F. 2d 404 (C. Cl. 1969); Brown v. United States, 396 F. 2d 459 (Ct. Cl. 1968); Oritt v. United States, 357 F. 2d 692 (Ct. Cl. 1966); Broome v. United States, 170 F. Supp. 613 (Ct. Cl. 1959); Carl Shapiro, 40 T. C. 34 (1963); A. A. Helwig, 37 T. C. 1046 (1962); William R. Lovett, 37 T. C. 317 (1961); Morris R. DeWoskin, 35 T. C. 356 (1960).

Except for immaterial variances as to names, amounts, the securities, and the forms of the transactions, the cases under consideration come within the reasoning of the cases cited above and the holdings that certain transactions were a sham. In Knetsch, supra, it was held that amounts claimed as "interest" could not be deducted where the transaction which gave rise to the claimed deduction was a sham. See Morris R. DeWoskin, supra; Gordon MacRae, supra; Rubin v. United States, supra. In these cases considerable attention was given to form, and petitioners rely heavily upon the form of each step taken. However, we do not find any differance in the substance of the transactions in Land Bank bonds, and Treasury bonds and notes in these cases upon making comparisons with the cases cited above. The findings, conclusions, and decisions in the cited cases were arrived at because the substance of each of the respective transactions in issue in each of those cases differed from its form. In these cases, the divergence of substance from form is as great or greater than in the cited cases.

We find no significant difference between the facts of these cases and those of Gordon MacRae, supra, after carefully and fully considering the evidence here, and all of petitioners' assertions, contentions, and arguments in their lengthy briefs.

All of the cases cited by petitioners have been considered. L. Lee Stanton, 34 T.C. 1, is distinguishable from these cases. In Stanton the Commissioner conceded that the transactions in issue were bona fide and real, and that they created genuine indebtedness. He has not made any of those concessions in these cases. In Stanton this Court concluded that the taxpayer undertook to run the risk of the rise and fall of the market. We cannot make that conclusion here. See Max Barnett, supra, p. 281.

It is recognized here, as was done in Knetsch v. United States, supra, affirming 272 F. 2d 200 (C.A. 9, 1959), that one of the principles stated in Gregory v. Helvering, 293 U.S. 465, is that a taxpayer has a right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, if he employs "means which the law permits," and that rule has been considered in these cases. However, the related rule is equally well settled that in instances of the type such as is in issue here "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." Gregory v. Helvering, supra. That rule of law requires that we first look beyond the form in which the transaction in question was cast.

Under the statute involved here, the petitioners may prevail "only if the payments in question were in fact and in substance

interest, i.e., consideration paid for the use and forbearance of money. Cf. Deputy v. Du Pont, 308 U.S. 488." See Gordon MacRae, supra, p. 26. The statutory provisions involved here, sections 23(b), 1939 Code, and 163(a), 1954 Code, pertain to a type of allowable deduction. Deductions are matters of legislative grace, and to obtain the benefit of a statute permitting a deduction of a specified type, the taxpayer must prove and establish that his claimed deduction comes within the provisions and specifications of the statute. As has been restated recently in Brown, et al. v. United States, 426 F. 2d 355 (May 15, 1970, Ct.Cls.), where a taxpayer "attempts to use the tax system to obtain a benefit or advantage where the only possibility of any real benefit or advantage comes through the tax mechanism itself," and where "there would be no substantial benefit or advantage through the transaction alone, apart from the operation of the particular tax mechanism employed by the taxpayer," the courts should examine carefully such attempts. "Such attempts may not always be rejected per se, but we think that a universal precondition of acceptance for tax purposes is that the taxpayer 'turn square corners' and fulfill every legislative requirement of tax law, correctly construed."

Knetsch v. United States, supra, is not favorable to petitioners' claims in these cases but to the contrary supports the respondent's determinations. See Rubin v. United States, supra, p. 770, where the court noted that Knetsch is not inconsistent with the cases cited by the Government. Cases cited by the petitioners, such as the following, are distinguishable from these cases because in them the courts found the transactions to be

in substance what they appeared to be in form and to have commercial reality: Maysteel Products, Inc. v. Commissioner, 287 F. 2d 429, reversing 33 T. C. 102; and Fabreeka Products Co. v. Commissioner, 294 F. 2d 876, reversing 34 T. C. 290. See Max Barnett, supra, p. 281, where the same observation was made.

On the authority of the decisions of the cases cited above (in the long list set forth at the beginning), the general question is decided for the respondent.

In view of the assertions and contentions of the petitioners in their lengthy briefs, it is advisable to discuss the facts, and the substance of the transactions in question, which purported to involve Federal Land Bank bonds and Treasury bonds and notes. Further discussion is necessary because of the diametrically opposite views, of the substance of the purported transactions, of the petitioners and the respondent, respectively, particularly because the petitioners contend that the form and the various steps of each transaction were in substance what they appeared to be in form.

The ultimate question and the subsidiary questions are questions of fact.

In parts of the petitioners' assertions on brief, there are several examples of their failure, whether or not deliberate and obtuse, to recognize important facts and distinctions; and there is a tendency, whether or not intentional, to obfuscate the real facts underlying some of the steps employed in the transaction. Moreover, our task in clearly making the findings has been an exceedingly tedious and time-consuming undertaking

because the seemingly simple structure of the transactions and of the provisions in the promissory notes given to Gibraltar were far from simple and uncomplicated.

It should be made clear that the many schedules set forth in the findings are the result of this Court's diligent and careful analysis of the relationship of one step to another, and of the necessary comparisons of steps followed by Gibraltar with steps followed by petitioners, particularly with respect to the steps followed by Gibraltar in making payments to Rosenthal, with which, of course, he was entirely cognizant.

The obligation of this Court to look through form in order to ascertain substance, so that the realities and substance of the steps employed as well as of the entire transaction would emerge, has not been an easy task to execute. The design and structure of the underlying plan of each transaction, including the promissory note to Gibraltar which in the principal amount included a so-called "reserve," were in many ways ingenious in their employment of the form of certain commercial and financial procedures. Descriptive labels were used, such as "short sale" which were not real at all in substance. There were no "short" sales of bonds and notes, and to describe what was done as a "short sale" was an artifice and subterfuge in itself. In order to understand the ingenuity of the general plan and of the separate steps employed, there must be an understanding of the evidence and of its significance which reflects understanding of the mechanics and procedures of those who are engaged in executing securities transactions. The fact that Cantor, Fitzgerald (C-F) and Gibraltar were closely related, although

separate, entities, that both were dealers in securities, and that each one had as its clearance agent in New York, the Chemical Bank and the Irving Trust Company, respectively, which in their other and major activities are actually engaged in the procedures of clearance agents in real securities transactions, created a trompe l'oeil which at first might fool the eye.

There was a great deal of eye-foolery in the steps which were employed, so that what was nothing at all appeared to have substance and to be a customary procedure in the business of buying and selling securities, of "delivering" them "against payment," and of "borrowing" securities to make a "short sale" of them. The transactions on their face had the appearance of the use and employment of money in substantial amounts, but relatively little money was employed.

Real transactions in the buying and selling of securities involve much paperwork and many bookkeeping entries. In the transactions in dispute, and in the steps employed, only the paperwork and the bookkeeping entries were real, not the purported use and borrowing of money, and not the purported acquisition of Land Bank bonds and Treasury bonds and notes. That the whole device and framework of each transaction were ingenious is demonstrated by the lengthy Findings of Fact and the many illustrative schedules of figures in the findings, which have been derived from the evidence as the result of a lengthy and tedious examination and analysis of the evidence by this Court, which counsel for the respective parties were not industrious enough to supply.

This Court, having worked out the findings, with the schedules, might find it sufficient to dispose of the questions involved simply by referring to the findings as dispositive of the ultimate question for decision, with the observation that petitioners' assertions and contentions are wholly lacking in merit. But it appears to be advisable to discuss and comment on some of the mechanics used in the transactions, so that the "eye-catching trompe l'oeil," or the deceptions, will not persist. Furthermore, since the petitioners have engaged in the exercise on brief of attempting to distinguish these cases from the decided cases in which the transactions which were not recognized for tax purposes were almost the same or closely similar to the transactions in dispute here, we must laboriously repeat here the analyses in the typical authorities which are controlling, even though in doing so we are obliged to largely quote from them.

Petitioner, Rosenthal, argues that the four transactions here were not "paper transactions," or sham transactions, and that they were not the type which has been described, in general, as Livingstone-type transactions. See Eli D. Goodstein, 30 T.C. 1178, affd. 267 F. 2d 127, supra. He argues, also, that these transactions were different from those involved (and not recognized for tax purposes) in the cases relied on by respondent and cited above, such as Max Barnett, Lynch, Rubin, Oritt, Nichols, and Lifschultz, (all supra), because each one of the transactions here was of longer duration (4 and 7 years) than were the short-term transactions in the cited cases, many of which were held to be merely paper transactions, some of which were for only 15 or 25 days, as in Bornstein v. Commissioner,

334 F. 2d 779 (C. A. 1, 1964); and Ippolito v. Commissioner, 364 F. 2d 744 (C. A. 2, 1966). Petitioner contends, further, that in each of the transactions under consideration, he entered into it to make an investment with the expectation of making a profit; that he ran a risk of loss which might result from market fluctuations; and that there was a reasonable possibility of making a profit; and that his motive in each instance was to make a profit. Petitioner contends that these transactions were similar to and should come under the reasoning of L. Lee Stanton, supra. He argues, in addition, that there was a reasonable expectation that in each of these transactions his economic interests would be beneficially affected, apart from any tax considerations.

All of petitioner's contentions have been fully considered. As his contentions do not present any new arguments which, in general, have not been considered in the many cases involving similar transactions, no useful purpose would be served in stating them in any more detail than as set forth above. Moreover, each case must be considered upon its own particular facts. In each case, the issues for decision largely involve fact questions.

Petitioner has observed correctly that in many (or most) of the cases in which similar transactions were in issue the length of time between the beginning and closing of the transaction was one or two years, whereas here the duration of each transaction was about $4\frac{1}{2}$ years, Transaction 1, 4-1/4 years, Transaction 4, and $7\frac{1}{2}$ years, Transactions 2 and 3. But, as has been stated frequently, in considering and deciding the question whether there is an actual indebtedness upon

which interest was paid for the use or forbearance of money, the transaction in issue must be considered in its entirety and we may not fragmentize the transaction; neither may we view one factor, without all of the others, as determinative if there is not clear proof that the taxpayer incurred an actual indebtedness. Gordon MacRae, 34 T.C. 20, 26, supra.

In MacRae, where the transactions closely resembled those in issue here, only two taxable years were involved, 1952 and 1953. Some of the transactions were closed in later years which were not before this Court. In the transaction purportedly involving Federal Land Bank bonds due October 1, 1957, callable October 1, 1955, the taxpayer's promissory note payable October 1, 1955, was renewable to October 1, 1957, and if it was extended to that date, the transaction had a duration of 4½ years. With respect to other transactions, we noted at page 24 that they were closed out subsequent to the taxable years, and we did not make findings regarding the dates of the closing of those transactions. It seems evident that in MacRae, this Court did not find it to be a determinative or even a material factor that each transaction was closed three, four, or five years after it was begun, whatever were the facts.

Here, with respect to each transaction, the fact that the duration was either 4 or 7 years, or more, does not contribute to, and is not determinative of, the finding and conclusion that there was no indebtedness incurred or owing by Rosenthal, and that the payments pursuant to each purported promissory note were not payments of interest on an existing indebtedness within the meaning of the

applicable statute. Petitioner's point and argument about the length of time involved in each transaction has been considered, and comparisons have been made of these cases with the many others previously decided by this Court and other courts, but on the basis of all of the facts in each transaction here we are unable to ascribe any particular or special weight and significance to the fact that a transaction extended over 4 or 7 years. In each instance, that fact is not helpful to petitioner in view of all of the facts of a transaction, and after taking into account an entire transaction. Furthermore, we think it is significant that in the MacRae case, which so closely resembles these cases, this Court did not find it material or of special significance that some of the transactions extended over a period of more than two years.

We turn now to petitioner's general argument that the instant transactions should be recognized for tax purposes because petitioner allegedly entered into each one for the purpose and with the hope of realizing a profit from an "investment." It is noted first that those general contentions and arguments have been made largely as assertions, per se, without connecting the bare assertions with the evidence. The presentation of bare assertions, unsupported by facts, cannot be given much weight because such unsupported arguments beg the question in issue. The applicable statute requires that the taxpayer shall prove that he incurred an existing indebtedness and that the payments for which interest deductions are claimed were in fact payments of interest on an existing indebtedness.

Petitioner has failed in his arguments to recognize that in the long list of previously decided cases involving claims for deductions of alleged interest on indebtedness, the courts have applied at least two general tests to determine the deductibility of payments which were said to be payments of interest. In Rothschild v. United States, 407 F. 2d 404 (Ct. Cls. 1969), supra, Judge Skelton made a painstaking review of the decided cases in this area which provides guidance and assistance, in general, and particularly in considering petitioner's arguments here. It was noted in Rothschild, supra, pp. 406-407, as follows:

> One test is commonly called the "business purpose test." According to this, interest is not allowed to be deducted if no economic gain could be realized beyond a tax deduction. Another test, commonly known as the "sham test," is involved in determining whether there is a genuine indebtedness. Here, the courts examine the circumstances surrounding the transaction in order to determine whether the transaction is a sham. If so, then they find that absent any substance to the transaction, there can be no finding of a genuine indebtedness.

In Rothschild, pp. 407-408, the Court pointed out that in the cases of Goodstein, Lynch, Broome, and Oritt (all supra), the court, in each case, looked through the form of the transaction "in order to determine the true substance," and where the court found that the transaction did not give rise to an actual indebtedness and there was no true obligation to pay interest, the alleged interest payments

are not deductible under section 23(b), 1939 Code, or section 163(a), 1954 Code. The Court, in Rothschild, also noted that in the cited cases, the court which decided the particular case looked to the substance of the transaction "without any regard for the tax consequences. Its only interest was to determine whether the transaction was a sham."

In Rothschild, p. 408, the court observed that in the decided cases where the "business purpose test" was applied, those cases did not involve sham situations, but, instead, were concerned with transactions of substance, and dealt primarily with "the problem of whether or not interest [deduction] is to be allowed to a taxpayer in a transaction where he could realize no economic gain apart from a tax deduction."

We resume, now, our considerations of petitioner's arguments. Our first approach must be to consider whether any or all of the transactions in issue were sham transactions, i.e., whether the so-called "sham test" is to be applied, or the "business purpose test." On this point, the evidence considered as a whole compels us to apply the "sham test." Of course, it is true, as petitioner points out, that M. Eli Livingstone, a Boston broker and dealer, was not involved in any of the instant transactions. See Eli D. Goodstein, 30 T.C. 1178, 1179, supra. Nevertheless, in form, the transactions here were of the same general pattern and type as a so-called Livingstone-type transaction.

In these cases, the proper test to be applied is, in our opinion, to look through the form of each transaction in order to determine

the true substance. That test has been applied to each transaction; the Findings of Fact represent the application of that test, and we shall now discuss each transaction:

In Transaction 1, in form, there was a sale to Rosenthal of $1,000,000 Land Bank bonds on February 11, 1953, according to a confirmation advice of Cantor, Fitzgerald. There were directions to Gibraltar to "receive" the bonds and pay the charges to C-F. Jack Bernstein's testimony was given to explain the mechanics of this transaction due to his inability to produce, in response to respondent's subpoena, the confirmation advices of Irving Trust (or copies thereof) to Gibraltar which Irving Trust customarily issued as Gibraltar's clearance agent in receiving securities against payment for Gibraltar. Bernstein testified, and the record does not indicate that his testimony should not be regarded as correct, that in every transaction for the account of Rosenthal, namely those in issue here, including Transaction 1, two steps were followed on or about the same day; securities were purchased from a dealer and on or about the same day the same securities were sold back to the same or another dealer by Gibraltar, and that Irving Trust handled the receipt and the redelivery of the same securities for Gibraltar's account, charging the account for the securities received, and crediting the account with the proceeds of the sale thereof. Bernstein testified that this procedure was followed in the transaction involving the $1,000,000 Land Bank bonds. No money was borrowed and none was involved. The immediate sale to a dealer covered the charges for the almost simultaneous purchase; the immediate sale nullified the

purchase; the purchase and sale on or about the same day made the purchase a "wash-out."

On September 5, 1957, less than 30 days before the maturity date of that issue of Land Bank bonds, the transaction was closed out on paper. At that time, Gibrlatar and C-F simply reversed the process. Gibraltar made a purchase, evidently in its own name, of $1,000,000 Land Bank bonds of the same issue, due October 1, 1957, and then C-F sold those bonds on the same day. The respective clearance agents, Irving and Chemical, received and redelivered the bonds against payment, and the respective accounts of C-F (with Chemical) and of Gibraltar (with Irving) were debited and credited for a "purchase" from one dealer and a sale to another dealer, and no money was involved. Again, there was a purchase from a dealer of bonds, and an immediate selling back of them to the same or another dealer. This mechanics simply provided the appearance of a sale of bonds for Rosenthal's account and, also, the details for a bookkeeping credit thereto for the proceeds of a purported sale of bonds for Rosenthal's account.

In reality, however, the transaction did not involve any real Land Bank bonds; none were held and "pledged" with Gibraltar from February 11, 1953, to September 5, 1957; and no real money was involved. Land Bank bonds were not actually delivered either to Rosenthal or to Gibraltar for his benefit, and neither ever had physical possession of the bonds. No payment was made to C-F or to a dealer in bonds, for the bonds, by either Rosenthal, or C-F, or Gibraltar purportedly purchased for Rosenthal. No funds were advanced by C-F or Gibraltar to Rosenthal to purchase the bonds. Even

though Rosenthal sent checks to Gibraltar, 1953-1955, totaling $97,777.56, in the guise of payments of interest, those payments could not constitute payments of interest on indebtedness because no funds were advanced and loaned to Rosenthal, or paid by Gibraltar or C-F to any dealer or anyone on his behalf. Neither Gibraltar nor C-F paid out $961,611.11 for Land Bank bonds; they did not get a loan of funds from a bank to advance to Irving Trust to make payment for bonds, and they did not borrow that sum from Irving Trust. Furthermore, Rosenthal did not make periodic payments from his own funds of the amounts of the purported interest on his initial note to Gibraltar because in each instance Gibraltar refunded, paid back, or "loaned" him most of each periodic payment in the guise of making payments to him of a so-called "reserve" of $90,388.90, so that by September 15, 1955, Rosenthal had paid Gibraltar $7,388.66 rather than $97,777.56, for which he took deductions on his tax returns.

Because there were not any Land Bank bonds, Gibraltar did not receive any coupon interest on bonds; it did not receive bond interest of $17,500 a year for 1953, 1954, and 1955, but nevertheless it credited Rosenthal's book account with that amount for 3 years, $52,500, so as to reduce the principal amount of the note from $1,052,000 to $999,500 which then became the amount of Rosenthal's so-called "renewal" note. The credits of $52,500 also performed the function of wiping out that much of the "reserve" of $90,388.90, which had been included in the principal amount of the first note.

Then Gibraltar continued to make credits to Rosenthal's account in 1956 and 1957

purportedly for earned interest on Land Bank bonds totaling $26,250, and Gibraltar even paid that sum to Rosenthal, and those payments to him constituted refunds to him of his cash payments in the guise of interest on his second note to Gibraltar so that his net payments were only $375.56, rather than $26,625.56.

Finally, the book account was closed as of September 6, 1957, without any real sale of any actual bonds by a credit to a balance of "principal" due of $999,500, reduced by 5 cents to $999,499.95, of an amount which would have been realized on the market if any real bonds had been sold, namely, $997,937.50, and there was an additional credit (for purported accrued bond interest at September 5, 1957) of $3.79, or a sum of credits of $997,941.29. Those book credits left a balance "owing" by Rosenthal of $1,558.66 which he paid to Gibraltar.

The entire transaction in Land Bank bonds was merely a paper transaction which, therefore, did not result in any indebtedness on the part of Rosenthal to Gibraltar. He did not incur an indebtedness of $1,052,000 to Gibraltar or any other party. His checks to Gibraltar, in the guise of interest on his two notes, totaling $124,403.12 (before refunds) therefore did not constitute "compensation for the use or forbearance of money." Also, Gibraltar's charges on the books in Rosenthal's account for purported "interest," totaling $131,934.05 (which were credited for petitioner's cash payments of $124,403.12, plus the credit on September 6, 1957, or $7,530.93 for so-called accrued bond interest) were not charges "for the use or forbearance of money." The transaction was a sham, apart from the tax aspects, and therefore

cannot be recognized as the basis for the claimed interest deductions aggregating $131,934.05 during the years 1953-1957. The claimed interest deductions in each of those years are not allowable under section 23(b), 1939 Code, and section 163(a), 1954 Code.

Moreover, no real capital gain was realized by Rosenthal. Only on paper was there a capital gain of $42,937.50. Rosenthal did not receive such gain; none was paid to him. Instead, at the end of the paper transaction in 1957, his book account showed a balance of $1,558.36, which he paid to Gibraltar to close the book account. The paper transaction cost petitioner $9,322.88, which represented a fee, which he paid to Gibraltar, for its accounting and paper-work services but not for the "use or forbearance of money." That was a fee for expected tax deductions.

The same kind of observations apply to transactions 2, 3, and 4. The mechanics and form employed in each of those transactions were even more obvious than in Transaction 1. On February 26, 1954, $100,000 Treasury bonds were purchased from Faroll. On the same day, the same bonds were sold back to a dealer, Childs. In substance and reality, the transaction did not involve any real Treasury bonds or any real money. The transaction was closed on September 15, 1961, by Gibraltar's bookkeeping credit of $100,000. As the Findings of Fact show, and we need not repeat them, Transaction 2 did not result in any indebtedness owing by petitioner. His checks to Gibraltar, and Gibraltar's charges on its books, therefore, did not constitute either charges or "compensation for the use or

forbearance of money." Gibraltar's charges and petitioner's payments in the guise of interest aggregating $21,111.11 were not payments for interest on indebtedness. The claimed interest deductions under Transaction 2 for the years 1954-1958 are not allowable.

In Transaction 3, $100,000 Treasury bonds were purchased from the dealer, Faroll, with the closing date of March 1, 1954. On the same date, the same bonds were sold back to another dealer, Devine. The entire transaction was closed out on Gibraltar's books, on paper, on September 14, 1961, by Gibraltar's credit of $100,000 to petitioner's account. In reality and substance, Transaction 3 did not involve any real Treasury bonds or any real money, and it did not result in any indebtedness owing by Rosenthal. Thus, Gibraltar's charges for "interest" and petitioner's payments to Gibraltar in the guise of "interest" did not constitute charges and "compensation for the use or forbearance of money." Therefore, the claimed deductions for the years 1954-1958, aggregating $21,088.15, are not allowable because they were not payments of interest on indebtedness.

In Transaction 4, in form, $750,000 Treasury notes were purchased from the dealer, Faroll, on December 23, 1955. On the same day, the same securities were sold back to a dealer, Ehlenberger. The transaction was closed on Gibraltar's books on April 1, 1960, by Gibraltar's credit to the account of petitioner of $750,000. In reality and substance, the transaction did not involve any real Treasury notes or any real money. Transaction 4 did not result in any indebtedness owing by Rosenthal to Gibraltar. Thus,

Gibraltar's charges for "interest" and petitioner's payments to Gibraltar in the guise of "interest" did not constitute charges and "compensation for the use or forbearance of money." Therefore, the claimed deductions for the years 1955-1960, for purported "interest" charges by Gibraltar aggregating $73,374.88 (exclusive of $7,723.67 charged by CHK) are not allowable because they were not payments of interest on indebtedness.

In Transaction 4, there was an additional step involving an advance to petitioner of $37,500 by CHK on December 23, 1955. There is a separate question to be decided involving this step. Petitioner paid to CHK, as prepaid "interest" for 4 years and 3 months, on December 23, 1955, $7,723.67, pursuant to a promissory note which he gave to CHK. Respondent had the burden of proving (rather than the petitioner) that there was not any indebtedness owing by petitioner to CHK and that the payment of $7,723.67 was not a payment of "compensation for the use or forbearance of money." Respondent made the claim in his pleadings that no deduction was allowable for $7,723.67; he had not made that determination in his statutory notice of deficiency.

Petitioner argues that respondent failed to introduce any evidence about this particular matter, and that he failed in his burden of proof. It is held that respondent carried and discharged his burden of proof. He introduced the testimony of a former bookkeeper employed by Gibraltar, Betty Young, and bookkeeping records of Gibraltar. There are set forth in the Findings of Fact the facts established by respondent's evidence and proof. They need not be repeated in detail.

The evidence establishes that on December 23, 1955, Gibraltar advanced funds to CHK, as a "loan" to CHK, and that in a loan account on Gibraltar's books in the name of CHK (a partnership closely related to Cantor, Fitzgerald) there were debit entries aggregating the total sum advanced to CHK, $106,250; and that the debit entries were for the component parts of the total sum which showed the payees of those component amounts, respectively; and that one of the subsidiary debit entries was in the amount of $37,500 payable to Rosenthal.

The evidence shows, also, that on December 23, 1955, Rosenthal wrote checks for disbursements totaling $38,622.89, which included a payment to Gibraltar of $25,301.11, in the guise of payment of interest to Gibraltar, as well as a payment to Faroll, which in reality was for the account of Gibraltar with respect to Gibraltar's instructions to Irving Trust. Rosenthal's disbursements included, too payment of $7,723.67 to CHK, in the guise of a payment of "interest." Absent evidence to the contrary (which petitioner had the opportunity to introduce in rebuttal to respondent's evidence), the reasonable inference to be made from all of respondent's evidence is that CHK, in turn, paid back to Gibraltar the $7,723.67.

Thus, there was merely a financial round robin on December 23, 1955, consisting of a transfer by Gibraltar to Rosenthal of $37,500, through CHK as a conduit, and transfers back to Gibraltar of $38,622.89, directly and indirectly. The transfer of $37,500 to Rosenthal created the appearance of a "loan," and of a basis for a charge for a charge for "interest," and of the appearance of

prepayment of "interest" of $7,723.67. The payment of $37,500 to Rosenthal was for one day. He paid it back to or for the benefit of Gibraltar on the same day. Therefore, he did not become indebted for that amount, and the momentary advance of cash to him was, again, a paper transaction for the purpose of providing the semblance of a loan and a prepayment of interest of $7,723.67. Broome v. United States, 170 F. Supp. 613, supra.

Moreover, the clear inference from all of the evidence is that the advance of $37,500 to petitioner was part of Transaction 4 with Gibraltar; and that the advance of $37,500, and the transfer back of that amount on the same day, was in substance the same as a cash "reserve" to be advanced by Gibraltar, as was done in transactions 1, 2, and 3.

The item of $37,500 was closed out on Gibraltar's books in May 1960 by a credit of $37,500 in the account with CHK to the subsidiary charge under the name of Rosenthal. There was another round robin of $37,500 from Gibraltar to Rosenthal, Rosenthal to CHK, and CHK to Gibraltar, which originated in Gibraltar's credit of $750,000 in the account of Rosenthal on its books on April 1, 1960. The item of $37,500 was part of the entire paper transaction.

As between Rosenthal and CHK, on December 23, 1955, in substance and reality $37,500 was not loaned to Rosenthal and his note to CHK was not evidence of an indebtedness by Rosenthal, payable to CHK on April 1, 1960. Although there was a transfer of that amount of cash through CHK, as a conduit, to Rosenthal, Rosenthal acted as a conduit, to

Rosenthal, Rosenthal acted as a conduit, also, in immediately disbursing the $37,500 on the same day back to Gibraltar and for its benefit. The $7,723.67, therefore, was not "compensation for the use or forbearance of money," and a deduction is not allowable in that amount because it was not a payment of interest on indebtedness.

Each one of the four transactions here, including the CHK transaction in Transaction 4, is practically identical to the type of transaction in the long line of cases where the "sham test" was applied, Oritt, Broome, Goodstein, MacRae, Rubin, and Nichols, all cited hereinbefore. Cantor, Fitzgerald and Gibraltar adopted, in general, the form of the Livingstone-type arrangements. In affirming this Court in Perry A. Nichols, 37 T.C. 772, supra, the Court of Appeals for the Fifth Circuit, 314 F.2d 337, supra, said:

> The trouble with the plan was that it was a complete and total sham, utterly lacking in substance. *** Although the taxpayers signed notes and paid interest, they could not under any theory be held as indebted under the facts as they appear.

Oritt v. United States, 357 F.2d 692, supra, presents a clear and succinct analysis of a transaction which was closely similar to the form of each one of the transactions here. See, also, Jockmus v. United States, 335 F. 2d 23, supra.

The transactions here did not involve any borrowing of funds by Gibraltar or Rosenthal from another party, such as a bank, with delivery of securities to the bank or its agent

to secure such bank loan. See, for example, Rothschild v. United States, supra, where there was a loan of $1,500,000 by the Mellon National Bank and Trust Company to which the taxpayer gave his full recourse promissory note, and Treasury notes were sent to the New York correspondent of the lending bank to be held as collateral for the promissory note. The taxpayer prepaid $60,135.42 interest on his note to the lending bank. About seven months later, the bank redeemed the Treasury notes, on their maturity date, August 15, 1956, and applied the proceeds in satisfaction of the loan. There were two other similar transactions. The issue was whether interest deductions were allowable. The Court of Claims held, p. 408, that the transactions were not sham transactions as there was substance to them; money was borrowed and the taxpayer was personally liable on his notes. Securities were purchased, with the borrowed funds, and were pledged to secure the notes. The court held that each transaction "was real and legal in all respects," p. 408, and that the "sham test" should not be applied. The court applied the "business purpose test," and the following explanation was given, p. 408:

> We turn now to the "business purpose test cases." Obviously, these cases do not involve sham situations, but are concerned with transactions of substance that are legal and binding on the parties. They deal primarily with the problem of whether or not interest is to be allowed to a taxpayer in a transaction where he could realize no economic gain apart from a tax deduction. * * * Some of the cases

emphasize the motive of the taxpayer and hold that where there is no business purpose except to gain a tax deduction, the interest is not deductible. Other decisions say that if the transaction is a scheme to avoid taxes, it is a sham even though a legal undertaking, and the interest cannot be deducted. Still other cases say the motives or purposes of the taxpayer are immaterial and the interest deduction will be allowed if there is a genuine indebtedness. Some of the courts hold that the deduction will be disallowed if the transaction does not appreciably affect the beneficial interest of the taxpayer, apart from taxes; * * *.

After reviewing the reasoning in Gregory v. Helvering, 293 U.S. 465, supra; Knetsch v. United States, supra; Diggs v. Commissioner, 281 F. 2d 326, certiorari denied 364 U.S. 908; Max Barnett, supra; Lifschultz, supra; and other cases, the court concluded in Rothschild, p. 417, that the claimed interest deduction was not allowable because the transaction could not "appreciably affect his beneficial interest except to reduce his tax. There was no way he could have made a profit except for the tax deduction. * * * He meets none of the other tests suggested to sustain a proper interest deduction."

In our view, the court's review, Rothschild, of the long line of cases dealing with the interest deduction cases provides a needed clarification of the distinction to be made between a transaction which is a sham, that is merely a paper transaction, and other kinds of transactions where, as part of an over-all plan, there are actual purchases of

securities with funds which actually were loaned to purchase securities.

The petitioner, in these cases, does not admit that each one of the transactions here, including the one with CHK, was merely a paper transaction and a sham. However, petitioner has failed to overcome the evidence introduced by respondent (over his objections) which clearly establishes that each one of the transactions in issue was a sham. Moreover, petitioner, under his burden of proof, failed to establish that in substance and reality there were actual and real loans of funds and that Government securities were involved.

Upon all of the evidence relating to each transaction, the findings are made that all of the transactions were merely paper transactions, therefore shams; that no real money was borrowed, loaned, or involved, and therefore that there were no indebtednesses owing by petitioner; that in each transaction no securities were involved, and that there were not any "short sales," even, of securities. It follows from those findings that no interest deductions are allowable. If it has not been clear to petitioner that where a transaction is a sham, no interest deduction is allowable, the extensive review of a long line of cases in Rothschild may clarify the confused approach in petitioner's brief. "It is clear from the foregoing cases and the statute that where a transaction is a sham, the interest deduction is denied to the taxpayer." Rothschild, supra, p. 417.

We are not called upon, therefore, to consider petitioner's arguments, which would be in point if these transactions had not been shams, to the effect that he had purposes other

than the hope to reduce his taxes in entering into each transaction, such as a purpose to realize a profit. Neither need we consider another contention, with which we do not agree, however, that in each transaction there was a risk of loss from market fluctuations, apart from the loss which was built into each transaction. Such arguments are of no avail to petitioner because each transaction was a sham. Therefore, no deductions are allowable for the purported "interest" payments. See Knetsch; Lewis v. Commissioner, 328 F. 2d 634, supra; and Nichols, supra.

Petitioner mistakenly relies upon L. Lee Stanton, supra, as has been noted above. In addition to our own observation about Stanton, references are now made to Rothschild, p. 412, and Oritt, supra, where the court distinguished Stanton, as we do here.

We should note, further, petitioner's contention that he should prevail under the reasoning of Maysteel Products, Inc. v. Commissioner, supra, and Fabreeka Products Co., supra, to which references have been made hereinbefore. Petitioner's citations of those cases are part of his argument, which in effect is, that none of the transactions here was a sham, and that in each one he had a motive and possibility of making aprofit (or did allegedly make a profit). In Rothschild, p. 412, the court considered Maysteel and Fabreeka in connection with "the business purpose test" cases, which, of course, do not apply here because these were sham transactions, and noted that in those cases "the taxpayer had a possibility or opportunity to make a profit on the transaction * * *, apart from the tax deduction."

Maysteel and Fabreeka are distinguishable from these transactions, which were shams, and do not apply. "The courts said the motives of the taxpayers were immaterial and allowed the tax deductions on the grounds that the taxpayers on buying the bonds had all the rights of ownership, including the possibility of making a profit * * * or the chance of losing money if their market declined." (p. 413, Rothschild; italics added.) In the transactions here, Rosenthal did not in substance and in fact buy any securities; none were in fact involved.

Petitioner contends that evidence about Gibraltar's procedures in all of the transactions is immaterial and inadmissible, and continuing objections to the receipt of such subject matter into evidence were made during the trial. He argues that the admission of such evidence relating to Gibraltar's dealings with others, called "third parties," such as the dealers in Government securities and the clearance agents, is prejudicial as well as immaterial. He argues that he did not participate in or know of Gibraltar's procedures, that he was not consulted about and did not ratify them. He objects to any findings of fact about the activities of Gibraltar and of any "third parties" involved in Gibraltar's procedures, in which he did not participate. He also argues that he made actual purchases of all of the Government securities referred to in his promissory notes to Gibraltar; that his promissory notes to Gibraltar were valid and enforceable obligations under the laws of California and New York; that he had title to the securities which, in the notes, were said to be "pledged" with Gibraltar; and that by the terms of his promissory notes, Gibraltar was obligated to "return" the "pledged" securities or collateral of like kind.

Petitioner asserts that neither he, nor anyone acting on his behalf, ever was informed beforehand about what Gibraltar did with the "pledged" securities, and that he, and no one for him, ever consented or afterward ratified Gibraltar's procedures and usages of the "collateral." He relies upon the fact that throughout each transaction Gibraltar sent statements to him regarding the status of his accounts, all of which indicated to petitioner that in each transaction Gibraltar held the government securities for him. He contends that what Gibraltar did should not affect petitioner's "right to the deductions." Petitioner's arguments stress the forms of the transactions and are focused on the fact that he executed documents which purported to be promissory notes.

Other taxpayers have advanced the same arguments unsuccessfully and there is not any evidence in these cases, and there was nothing in the transactions themselves, which distinguish these cases from those where the same arguments were made but were not of any avail. See Lynch v. Commissioner, 274 F. 2d 867, 872, supra; and Nichols v. Commissioner, 314 F. 2d 337, 338 affirming 37 T.C. 772, supra.

In Nichols, p. 790, this Court rejected the same contention that the taxpayers' notes "were a valid indebtedness under Florida law," and were evidence of valid indebtedness. We said that the transactions were a sham and that "a sham remains a sham whether or not under seal."

In affirming this Court, the Court of Appeals for the Fifth Circuit, Nichols, supra, p. 338, was even more forthright. In the Nichols

case, Eli Livingstone dealt with the taxpayers, and a corporation, Corporate Finance, the president of which, Harry Cushing, was a former law associate of Livingstone, was the "third Party" which was used by Livingstone. The taxpayers signed and delivered "promissory notes under seal" payable to Corporate Finance. This Court referred to the notes in its findings, p. 777, as "documents purporting to be promissory notes under seal." The Court of Appeals stated the following:

> * * * The trouble with the plan was that it was a complete and total sham, utterly lacking in substance. The sine qua non of the plan was the purchase of securities which were, in turn, to secure the debt. They were purchased, but simultaneously sold. Although taxpayers signed notes and paid interest, they could not under any theory be held as indebted under the facts as they appear. * * *
>
> Taxpayers contend that these cases are distinguishable because they acted in good faith, intending that the transactions be bona fide, * * *. The fact is that the corporation [Corporate Finance and Loan Corporation] which acted for and at the instance of Livingstone as the necessary third party required to perpetrate the fraud represented to taxpayers in writing, after the short sale, in effect that it had Treasury Notes bearing specified numbers in its possession for the account of taxpayers. This representation was as false and fraudulent as the balance of the scheme. Nevertheless we are concerned with what was done, not why it was done.

United States v. General Geophysical Co., 5 Cir., 1962, 296 F. 2d 86, cert. den., 369 U.S. 849, 82 S.Ct. 932, 8 L. Ed. 2d 8. The intent of the taxpayers and their good faith is not involved.

> There was no substance to the transaction. It was a sham from beginning to end.

The same can be said here, because the 4 transactions here were closely similar to the transactions in Nichols. In these transactions Gerald Cantor and Canto, Fitzgerald acted in very much the same way as Livingstone did in the Nichols transactions, and Gibraltar and CHK were used, and could be used, by Cantor to carry out the transactions just as Corporate Finance was used in the Nichols transactions.

It is immaterial whether Rosenthal believed, or was told, that each one of his transactions involved an actual, real, and bona fide purchase of Government securities, which were to be and were held for his account by Gibraltar; that he was told, or believed, that he had incurred real indebtednesses for such alleged purchases; that he was let to believe by Gibraltar that such purchases of securities had actually been made for him, and that the alleged securities were being held for him; or that he believed that the documents he signed actually were bona fide and real promissory notes which were evidence of actual and real indebtedness. It should be rememberd that all of the purported promissory notes payable to Gibraltar were provided and filled in by Gibraltar, on its own printed forms, and were simply given to Rosenthal to sign.

The promissory notes were a chief and integral part of each plan, transaction, or scheme. They were not promissory notes of an unrelated and disinterested lending institution, such as a bank, which had no connection with Gerald Cantor or Cantor, Fizgerald.

We are able to be equally forthright, as was the Court of Appeals for the Fifth Circuit, upon the basis of all of the evidence in these cases, and it can be said with the same force here, that Gibraltar (and CHK in one instance) acted for and at the instance of Gerald Cantor and Cantor, Fitzgerald, "as the necessary third party required to perpetrate the fraud represented to" Rosenthal, to the effect that in each transaction, plan, or scheme, the Government securities described in each purported promissory note payable to Gibraltar had been purchased, were held, paid coupon interest, and finally were "sold" to produce capital gain, whereas none of such representations to Rosenthal were true. Such representations to Rosenthal were "as false and fraudulent as the balance of" each scheme and alleged transaction.

But the intent of Rosenthal and his good faith are not involved. The ultimate questions here, whether deductions are allowable for the purported "interest" payments under the applicable interest deduction provision of the Code, must be decided upon the evidence showing what was done, and not why it was done. There was no substance to each transaction, including the one with CHK, and all of the transactions were shams from beginning to end.

The rule has been stated in Lynch v. Commissioner, 273 F. 2d 867, 872, supra, where the Court of Appeals for the Second Circuit held that no effect could be given to the taxpayers' contentions that they "did not know of the round-robin nature of the transaction and believed they were incurring a debt to Gail." The court said:

> Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers. Beyond this, it would strain credulity to the breaking point to suppose that taxpayers had no inkling that something highly unusual was going on. (Italics added)

There is a large quantity of proof in the record in these cases about "the objective facts" in all of the transactions here. It covers and explains the steps followed by Gibraltar (and CHK) in all of these paper transactions. That evidence was received over petitioner's continuing objections on the ground of materiality and admissibility. On brief, petitioner argues that all of the evidence about the procedures, mechanics, and steps of so-called "third parties," Gibraltar, dealers, and clearance agents, should not be considered or given any weight because it is immaterial, prejudicial, and inadmissible. In support thereof, petitioner cites Niederkrome v. Commissioner, 266 F. 2d 238 (C. A. 9, 1959); Oregon and C. R. and Company v. Grubissich, 206 F. 577 (C. A. 9, 1913); and United States v. Feinberg, 140 F. 2d 592 (C. A. 2, 1944), but his reliance on those cases is misplaced as they do not apply here because on their particular facts they

are distinguishable.

Petitioner admits that respondent's evidence, which includes a great many documents, shows facts, procedures, and records which, per se, are true and show the procedures and steps which were followed by Gibraltar, clearance agents, dealers, and others. He stipulated with respondent that the exhibits which respondent intended to and did offer into evidence were in themselves true, but he strongly objected to the receipt thereof into evidence on the ground of materiality. Therefore, his objections are not directed at the authenticity of respondent's documentary and other evidence but, only to the materiality. Our opinion at the trial was, and it still is, that respondent's evidence is relevant, material, and admissible. That evidence was received into evidence because it is material in establishing the objective facts, the facts about what was done by Gibraltar, Cantor, Fitzgerald, CHK, Irving Trust, Devine, Childs, Ehlenberger, and all of the parties who participated in the intra mural procedures and mechanics employed and utilized by Gibraltar, CHK, and Cantor, Fitzgerald.

The provisions of section 23(b), 1939 Code, and section 163(a), 1954 Code, do not depend upon intent. Rather, they specify and require that there must be an existing indebtedness in order that a deduction can be allowed as a payment of interest on indebtedness. The respondent disallowed deductions for the claimed "interest" payments. His determinations were prima facie correct and petitioner had the burden of proving, (except in the instance of the payment in 1953 to CHK of purported "interest" with respect to which respondent had the burden of proof due to his

affirmative allegation in his pleadings) that the payments in issue were in fact payments for the use or forbearance of money, hence interest on actual indebtedness, Max Barnett, supra, p. 276. In spite of petitioner's burden of proof, respondent subpoenaed and offered the evidence relating to Gibraltar's procedures and mechanics for the purpose of proving the objective facts about whether there were or were not securities purchased and held for petitioner, whether there were or were not actual, real, and bona fide indebtedness owing by petitioner to Gibraltar (and to CHK); whether there was or was not substance to each transaction, as opposed to form; and whether each transaction was or was not merely a paper transaction and a sham from beginning to end. Respondent, therefore, offered evidence in support of his determinations. Petitioner failed to refute respondent's evidence, and he did not show that it was incorrect, immaterial, or inadmissible.

Petitioner argues that he has a "right" to the claimed deductions for interest but he does not have any prima facie "right" to the claimed deductions, and there is no statutory presumption with respect to such alleged "right." Rather, he had the burden of proving and establishing that the payments to Gibraltar were in reality and substance payments for the use or forbearance of money; that there were in substance and reality indebtednesses owing by him to Gibraltar and CHK. He failed to meet his burden of proof. If we were to approve petitioner's contention that evidence relating to the substance of the transactions is not admissible and material; that is, evidence about what Gibraltar actually did or did not do in the alleged lending of funds to petitioner, and in the purported buying of

securities for his account, the condition prescribed in sections 23(b) and 163(a), that there must be an existing indebtedness, would be defeated and nullified.

After the Court of Appeals for the Ninth Circuit decided the Grubissich and Niederkrome cases, it decided MacRae v. Commissioner, 294 F. 2d 56, supra, in which it cited with approval the ruling in Lynch relating to the relevancy of the objective facts, quoted above, in connection with the same question as is present here. Hence, it is clear that the cases relied upon by petitioner are not applicable to the transactions here in issue. In Perry A. Nichols, supra, this Court applied the rule of Lynch that the objective realities are controlling of the claim for interest deductions, and under closely similar facts we held, as we do in these cases, that regardless of what petitioner may have intended, believed, or expected, there can be no interest deductions under the statute, and the "good faith" of petitioner is irrelevant.

In Goodstein v. Commissioner, supra, the court observed, about similar transactions and facts, that although the transactions [between the taxpayer and Seaboard] seemed to have created a "legal relationship between the taxpayer and Seaboard," "it was not one of borrower and lender," but was "the exchange of promises of future performances between the taxpayer and Seaboard." In these cases, the purported promissory notes to Gibraltar, executed by petitioner, must be considered within the entire transaction, in each instance. Even though in form each promissory note was in conformity with legal requirements, nevertheless since in reality no funds were loaned to petitioner, and no securities were

purchased, the promissory notes in themselves were without substance as evidence of existing indebtedness, and in and of themselves the promissory notes did not create an existing relationship of borrower and lender. There was not real consideration for each purported promissory note.

Income from the transactions: Our findings and conclusions are that each transaction was a sham; no Government securities were in fact purchased by or for Rosenthal and held for him, or "pledged" to secure his notes; some "sales" for petitioner's account to Gibraltar, at the end, were made solely by bookkeeping entries; no coupon interest from any Government securities was in reality received by or due to petitioner; and no income from coupon interest or capital gain was realized by petitioner. Respondent has agreed that under Rule 50 there will be eliminated from taxable income the capital gains and coupon interest reported on the returns filed by petitioner (for himself and for his former spouse). However, there is one strange exception to this general matter:

In transaction 4, which ended April 1, 1960, Gibraltar paid from its own funds the net amount of $1,428.34. That item was not a gift by Gibraltar, and under the particular facts about the advance of $37,500 through CHK, as set forth in the findings, petitioner realized $1,428.34 taxable income. In the Rule 50 recomputation, that amount shall be included, or left in, petitioner's 1960 taxable income. The findings and ultimate findings explain this item and no further comment is necessary, except to note that this item was a net cash receipts item, received by petitioner

in 1956 (but not includable in income until 1960 when the entire transaction [4] ended). It is only a coincidence, in figures, that there was a "net economic gain" to petitioner in transaction 4 in the identical amount, $1,428.34, and our holding above on a different basis and for different reasons that petitioner realized income of $1,428.34 does not mean that the above amount constituted taxable income because there was a "net economic gain" in the same amount, (see p. 68, supra).

Instead, our holding about this particular item results from the simpler fact that petitioner reported income on a cash basis. As is set forth on page 62, supra, petitioner used $1,122.89 of his own funds in making several disbursements on December 23, 1955; and it is stated on p. 65, supra, that on April 1, 1956, Gibraltar made a cash payment to him (in the guise of Treasury note coupon interest) which was $2,551.23 more than petitioner paid to Gibraltar in the guise of a payment of "interest" on his promissory note; so that petitioner got back his $1,122.89, and he also received $1,428.34 from Gibraltar which was not a refund of any money previously paid out by petitioner. It is also shown on page 65, supra, that after April 1, 1956, the checks which Gibraltar and Rosenthal exchanged were always in the same amount, $5,625; and it is shown on page 66, supra, that the last item of $5,625 charged to petitioner was off-set by a bookkeeping credit in the same amount. Therefore, it is clear from the facts about the exchanges of checks between Gibraltar and petitioner that on April 1, 1956, petitioner realized taxable income, because it was cash income, of $1,428.34. That item would be income for 1956 but for the established rule, in this type of scheme,

that the year in which taxable income, if any, is realized is the year in which the "transaction" is closed. See the comment in Lynch v. Commissioner, supra, p. 872.

It is simply an odd fact that even though transaction 4 was a sham, and even though in general petitioner did not realize any coupon-interest-income from the Treasury notes (which he reported as income on the tax returns), nevertheless, Gibraltar managed to make a cash payment to petitioner out of its own funds in 1956, in a running account with petitioner, of $1,428.34 which was taxable income to petitioner.

That amount was taxable income in 1956. If under the peculiar circumstances here, that amount should be left in taxable income for 1956, we leave it to the parties to so agree under Rule 50. Or they may agree under Rule 50 to follow the rule that 1960 is the correct year for which to "pick up" that item because transaction 4 ended in 1960. Whether the item properly is to be picked up in taxable income in 1956 or 1960 is de minimis in this case, in any event, and we leave this item to the parties to agree upon under Rule 50.

We now turn to the matter of whether Rosenthal, an experienced lawyer, who seems to be acquainted with tax matters (see MacRae v. Commissioner, 294 F.2d 56, 57, supra, where he is shown as one of the taxpayers' attorneys), can be believed to have been totally unaware of Gerald Cantor's actual doings. For example, in Perry A. Nichols, 37 T.C. 772, 789-790, supra, this Court expressed a doubt (on the basis of the record in Nichols, of course) about the assertion of

complete innocence of the taxpayers there.

We are not inclined to give Rosenthal credit for total innocence about the transactions involving Gibraltar and CHK. The evidence is that Gerald Cantor arranged every transaction in issue here, and that Rosenthal was acquainted with Cantor. In each transaction, the due date of Rosenthal's promissory note was the same, or close to, the maturity date of the particular Government securities which purportedly were "pledged" to secure his promissory note, so that the credit to him for the terminating "sale" by him of the "pledged" securities was bound to be for or close to the par value thereof. Rosenthal has admitted that he discussed with Gerald Cantor the rate of "interest" to be charged by Gibraltar in each of his promissory notes (see page 7-(a), supra). The plan of each transaction was such that the end-result could be determined with complete or nearly complete accuracy at the time each transaction was commenced. That clearly was so in transactions 2, 3, and 4. Furthermore, the arrangement whereby Gibraltar and Rosenthal exchanged checks for "interest" in each transaction, so that Rosenthal received back almost all of his payments of note "interest" to Gibraltar, was so unusual by ordinary, business standards, that it is a strain upon credulity to be asked to believe that Rosenthal was totally unaware of the unusual aspects of all of the transactions. In transaction 1, he purportedly paid note-interest totaling $131,934.05, which was the sum of his tax deductions, but he actually parted with only $7,764.22, in cash, after receiving cash and credits from Gibraltar. The same pattern was present in the other three transactions,

transaction 2, note "interest" paid, $21,111.11 (also deducted), and net cash paid by Rosenthal, after refunds, $3,751.65; transaction 3, note "interest" paid and deducted $21,088.15, and net cash paid by petitioner after refunds, $3,876.56; transaction 4, "interest" on notes paid and deducted $81,098.55, and no net cash paid by petitioner after refunds, but a receipt from Gibraltar (taxable income, supra), of $1,428.34.

We think a realistic view of the circumstances here, on the basis of the entire evidence here, is and must be that Rosenthal had reason to know that the 4 transactions were not what they were purported to be, even though he did not have any actual knowledge of Gerald Cantor's actual and true maneuvers and Gibraltar's actual mechanics and procedures, and "it would strain credulity to the breaking point to suppose that taxpayers [Rosenthal] had no inkling that something highly unusual was going on." Lynch v. Commissioner, supra, p. 1188. In Perry A. Nichols, supra, p. 790, in considering a similar claim of innocence by the taxpayers, it was observed that there is a difference between genuine reliance upon another person's assurances and indifference about the other person's procedures. Assuming that Rosenthal did not have any actual knowledge of Gerald Cantor's and Gibraltar's procedures throughout each transaction, his acceptance of the form of each transaction and Cantor's assurances were realistically, a menas of isolating himself from the realities of each transaction, whatever they might be.

Rosenthal, during the years 1953, 1954, and 1955, signed promissory notes payable to

Gibraltar, and a note to CHK, in the total face amount of $2,012,000, in the four transactions which purported to involve the outright "purchase" of Government securities in the total face amount of $1,950,000 which, upon maturity, would be redeemed for the face amount of $1,950,000, or $62,000 less than the principal amount of his promissory notes. The Government securities purportedly were "purchased" for a total "cost" of $1,855,138.09. Rosenthal executed promissory notes ($2,012,000) in a total amount which was $156,861.91 more than the purported "cost" of the securities allegedly purchased, as follows:

Transaction	Promissory Notes	"Cost" of Securities
1	$1,052,000.00	$961,611.11
2	105,000.00	87,640.54
3	105,000.00	87,788.33
4	712,500.00	718,098.11
	37,500.00 (CHK)	
Total	$2,012,000.00	$1,855,138.09

The coupon interest purportedly to be paid on the Government securities which allegedly were "purchased" was less, in each instance, than the "interest" Rosenthal was to pay on his several promissory notes (and for some of the time no coupon interest was to be involved because of detached coupons). There is no evidence that Rosenthal acted in any respect as "purchaser" who intended to, or would, or could, "sell" the Government securities prior to the maturity dates of his promissory notes, and before the maturity dates of the Government securities, if market prices went above 100 (or par); and

the evidence as a whole shows that there was an intention to continue each transaction until the due date of each promissory note of Rosenthal, and no intention of calling upon Gibraltar to make a delivery to Rosenthal of any of the purportedly purchased Government securities.

Under all of the circumstances, in each transaction, Rosenthal must be considered to have been at least indifferent, if not an outright willing participant in Gerald Cantor's and Gibraltar's shams.

There is a lengthy argument of petitioner relating to the possibility of "arbitrary discrimination" against himself by the respondent in his determinations whereby he disallowed the claimed deductions for payments that were made ostensibly as payments of "interest." Petitioner refers to the rules that tax laws will not be administered so as to discriminate in favor of, or adversely to, some taxpayers, and that the tax statutes must be administered so as to afford a nationally uniform application. He cites Helvering v. Taylor, 293 U.S. 507, 514, where it was noted that if the respondent makes an arbitrary determination, then it should be set aside.

These arguments of petitioner are directed at this Court's denial of motions to take depositions, prior to the trial of these cases, of the highest administrative officials of the Internal Revenue Service, including the then Commissioner of Internal Revenue, the then Chief Counsel and Associate Chief Counsel, and the Custodian of Records, in order to determine facts relating to the treatment by the Internal Revenue Service of taxpayers who were "situated similarly" to the petitioner.

The arguments are directed, also, to the action taken by this Court in granting respondent's motion to quash certain subpoenas duces tecum which petitioner obtained and served on the above-described officials of the Internal Revenue Service. Those subpoenas, among other things, broadly asked for every document, record, and file of the Internal Revenue Service "of all taxpayers who ever paid interest to a lender on a loan secured by United States Government Notes or Bonds, the deduction of which was questioned by the Internal Revenue Service."

An earlier order of the United States Tax Court quashing earlier subpoenas duces tecum was upheld in MacRae v. Riddell, 350 F. 2d 291 (C. A. 9, 1965), affirming 234 F. Supp. 105, cert. den. in Melcher v. Riddell, 382 U.S. 977 (1966).

It has been petitioner's position, impliedly at least, that the respondent's determinations disallowing the claimed deductions for "interest" in these cases were arbitrary and discriminatory determinations, which denied to him equal treatment by the respondent, such as had been given to other taxpayers, and he has argued that it was error for the Tax Court to grant respondent's motion to quash the subpoenas duces tecum, and to deny petitioner's motions to take depositions of the above-described officials of the Internal Revenue Service.

Consideration was given to all of those matters, and it has been given to petitioner's arguments on brief relating to them.

It is noted that the now very long list of cases decided before now, involving the same

determinations of the respondent, disallowing deductions to other taxpayers, for purported "interest" payments by other taxpayers, who became engaged in Livingstone-type transactions, and in transactions involving Gibraltar, and other companies which performed the same or similar functions as Gibraltar, attest to the fact that the respondent did not act arbitrarily in making the determinations in issue here, and that many other taxpayers who were in the same or similar "situations" as the petitioner was in here received the same "treatment" as did the petitioner, from which these cases arose. It has been said often that each tax case must stand upon its own facts.

Similar arguments by other taxpayers, to the effect that "the doctrine of equality of treatment" requires the allowance to them of certain claimed deductions, have been rejected by many courts, as well as similar contentions that they have received "prejudicial discrimination." The courts have regarded such contentions as lacking in merit, and have rejected them. Cf., Weller v. Commissioner, 270 F. 2d 294 (C. A. 3, 1959), supra; Knetsch v. United States, 348 F. 2d 932, 940-941; Gerstell v. Commissioner, 319 F. 2d 131 (C. A. 3, 1963), affirming a Memorandum Opinion of this Court; Minchin v. Commissioner, 335 F. 2d 30 (C. A. 2, 1964); and Dixon v. United States, 381 U. S. 68 (1965); Carpenter v. Commissioner, 322 F. 2d 733 (C. A. 3, 1963); and Goodstein v. Commissioner, 267 F. 2d 127 (C. A. 1, 1959), supra.

We think there is no merit to petitioner's contentions about prejudicial discrimination. Also, it is our opinion that the receipt in evidence in these cases of evidence about

Gibraltar's and Gerald Cantor's procedures in each of the four transactions in issue, the so-called "third party" evidence offered by the respondent, was not error and that such evidence is material, relevant, and admissible.

There are some additional contentions to be considered before reaching petitioner's alternative contentions:

Upon all of the evidence, it is clear that petitioner's primary and only purpose in entering into each transaction was to obtain "interest" deductions and tax savings; and that Gibraltar was utilized to provide the facade of a seemingly valid debtor-creditor relationship. A taxpayer is entitled to arrange his undertakings so as to reduce, or even avoid, taxes provided that he does so by means which the law permits. But even though the motive of tax avoidance is to be excluded from consideration, the courts may and must look through the forms of transactions to determine whether the substance thereof comes within or outside of the intent of the applicable statute, so that artifice will not be exalted above reality so as to "deprive the statutory provision in question of all serious purpose." Gregory v. Helvering, 293 U.S. 465, 470 (1935); Knetsch v. United States, 364 U.S. 361 (1960), supra; and dissenting opinion, Judge Learned Hand, Gilbert v. Commissioner, 248 F.2d 399 (C.A. 2, 1957).

Apart from expected tax deductions and tax benefits, no economic gain and no economic benefit to petitioner could have been expected by him at the time he entered into each one of the four transactions. In the first three transactions, apart from tax considerations,

petitioner's beneficial interests were not affected, and were not increased, and he paid out more than he received. In the fourth transaction, apart from expected tax benefits, petitioner received from Gibraltar $1,428.34 in cash, which was more than he paid out, as has been explained. Even if that amount might be regarded as "gain" from the transaction, rather than simply a "bonus" resulting from the exchanges of checks between petitioner and Gibraltar in their running account with each other, which is what the $1,428.34 was, in fact, it is noted that a "gain" of $1,428.34 spread over the 5-1/4 years of Transaction 4 would amount to a gain of $272.06 a year, which is not exactly evidence of a reasonable expectation of profit on a purported investment of $750,000 (the sum of the notes to Gibraltar and CHK over a period of 5-1/4 years). The increment of income realized in Transaction 4 was de minimis and only emphasizes the conclusion that petitioner's purpose in entering into Transaction 4 was the same as his purpose in entering into the other three transactions, namely, to reduce taxes. See Williams v. Commissioner, 323 F. 2d 656 (C. A. 9, 1963), affirming a Memorandum Opinion of this Court, where (as in Transaction 4) the taxpayer purportedly borrowed money from two separate, but related, entities purportedly to "purchase" $1,000,000 United States Treasury notes, and its was held that both transactions were shams to be disregarded for tax purposes. See, also, Rubin v. United States, 304 F. 2d 766, 770, supra, where the court held that the fact that a profit was made on a transaction did not distinguish the case from MacRae, supra, since either a gain or a loss "was incidental to the chimerical character of the transaction."

Each one of the transactions was a paper transaction and a sham, apart from the tax purpose and each transaction cannot be recognized for tax purposes. There was not an existing indebtedness, in any of the transactions, owing by petitioner within the meaning and intendment of sections 23(b), 1939 Code, and 163(a), 1954 Code. It is held that no deductions are allowable for interest paid on indebtedness; respondent's determinations in the deficiency notices, and in his amended pleadings for 1953, are sustained.

Title 5 U. S. C. §552:

§ 552. Public information; agency rules, opinions, orders, records, and proceedings

(a) Each agency shall make available to the public information as follows:

(1) Each agency shall separately state and currently publish in the Federal Register for the guidance of the public—

(A) descriptions of its central and field organization and the established places at which, the employees (and in the case of a uniformed service, the members) from whom, and the methods whereby, the public may obtain information, make submittals or requests, or obtain decisions;

(B) statements of the general course and method by which its functions are channeled and determined, including the nature and requirements of all formal and informal procedures available;

(C) rules of procedure, descriptions of forms available or the places at which forms may be obtained, and instructions as to the scope and contents of all papers, reports, or examinations;

(D) substantive rules of general applicability adopted as authorized by law, and statements of general policy or interpretations of general applicability formulated and adopted by the agency; and

(E) each amendment, revision, or repeal of the foregoing.

Except to the extent that a person has actual and timely notice of the terms thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published. For the purpose of this paragraph, matter reasonably available to the class of persons affected thereby is deemed published in the Federal Register when incorporated by reference therein with the approval of the Director of the Federal Register.

(2) Each agency, in accordance with published rules, shall make available for public inspection and copying—

(A) final opinions, including concurring and dissenting opinions, as well as orders, made in the adjudication of cases;

(B) those statements of policy and interpretations which have been adopted by the agency and are not published in the Federal Register; and

(C) administrative staff manuals and instructions to staff that affect a member of the public;

unless the materials are promptly published and copies offered for sale. To the extent required to prevent a clearly unwarranted invasion of personal privacy, an agency may delete identifying details when it makes available or publishes an opinion, statement of policy,

interpretation, or staff manual or instruction. However, in each case the justification for the deletion shall be explained fully in writing. Each agency also shall maintain and make available for public inspection and copying a current index providing identifying information for the public as to any matter issued, adopted, or promulgated after July 4, 1967, and required by this paragraph to be made available or published. A final order, opinion, statement of policy, interpretation, or staff manual or instruction that affects a member of the public may be relied on, used, or cited as precedent by an agency against a party other than an agency only if—

(i) it has been indexed and either made available or published as provided by this paragraph; or

(ii) the party has actual and timely notice of the terms thereof.

(3) Except with respect to the records made available under paragraphs (1) and (2) of this subsection, each agency, on request for identifiable records made in accordance with published rules stating the time, place, fees to the extent authorized by statute, and procedure to be followed, shall make the records promptly available to any person. On complaint, the district court of the United States in the district in which the complainant resides, or has his principal place of business, or in which the agency records are situated, has jurisdiction to enjoin the agency from withholding agency records and to order the production of any agency records improperly withheld from the complainant. In such a case the court shall determine the matter de novo and the burden is on the agency to sustain its action. In the event of noncompliance with the order of the court, the district court may punish for contempt the responsible employee, and in the case of a uniformed service, the responsible member. Except as to causes the court considers of greater importance, proceedings before the district court, as authorized by this paragraph, take precedence on the docket over all other causes and shall be assigned for hearing and trial at the earliest practicable date and expedited in every way.

(4) Each agency having more than one member shall maintain and make available for public inspection a record of the final votes of each member in every agency proceeding.

(b) This section does not apply to matters that are—

(1) specifically required by Executive order to be kept secret in the interest of the national defense or foreign policy;

(2) related solely to the internal personnel rules and practices of an agency;

(3) specifically exempted from disclosure by statute;

(4) trade secrets and commercial or financial information obtained from a person and privileged or confidential;

(5) inter-agency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency;

(6) personnel and medical files and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy;

(7) investigatory files compiled for law enforcement purposes except to the extent available by law to a party other than an agency;

(8) contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions; or

(9) geological and geophysical information and data, including maps, concerning wells.

(c) This section does not authorize withholding of information or limit the availability of records to the public, except as specifically stated in this section. This section is not authority to withhold information from Congress. Pub.L. 89-554, Sept. 6, 1966, 80 Stat. 383; Pub.L. 90-23, § 1, June 5, 1967, 81 Stat. 54.

Title 26 U. S. C. §162:

§ 163. Interest

(a) **General rule.**—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Title 26 U. S. C. §7422:

§ 7422. Civil actions for refund

(a) No suit prior to filing claim for refund.—No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary or his delegate, according to the provisions of law in that regard, and the regulations of the Secretary or his delegate established in pursuance thereof.

Title 28 U. S. C. §1346:

§ 1346. United States as defendant

(a) The district courts shall have original jurisdiction, concurrent with the Court of Claims, of:

(1) Any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws;

RULE 44. SUBPOENAS

(*a*) *How issued.*—Subpoenas shall be issued to a proper party, upon request, and when issued shall be signed and sealed, but may otherwise be in blank. Subpoenas so issued in blank shall be completed before service by the party receiving them.

(*b*) *Contents.*—A subpoena when completed shall state the caption of the case, the names and last-known addresses of the witnesses to be called, the time and place at which they are to appear and give testimony, and whether a witness may designate someone to appear in his place.

(*c*) *For production of documentary evidence.*—If evidence other than oral testimony is required, such as documentary or written data, the subpoena shall number, set forth separately, and describe adequately each item to be produced.

(*d*) *Service.*—The party on whose behalf a subpoena is issued shall be responsible for its service, and service may be made by any person who is not a party and is not less than 18 years of age. Service of a subpoena upon a person named therein shall be made by delivering a copy thereof to such person.

No. 73-1303

APR 25 1974

In the Supreme Court of the United States

OCTOBER TERM, 1973

JEROME B. ROSENTHAL AND
RUTH B. ROSENTHAL, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Both the Tax Court and the court of appeals upheld the determination of the Commissioner of Internal Revenue that certain transactions of petitioner,[1] involving purported loans and interest payments, had no substance for tax purposes so that claimed interest deductions were disallowed. See *Knetsch* v. *United States*, 364 U.S. 361. Petitioner does not attack the substance of the decision below. Rather, he raises several procedural and constitutional arguments.

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[1]References to "petitioner" are to Jerome B. Rosenthal. Ruth B. Rosenthal is a party only because she filed a joint income tax return for the years in issue with petitioner.

1. Petitioner argues (Pet. 7-10) that under the Seventh Amendment he was entitled to a jury trial of his tax dispute. The Seventh Amendment, however, does not apply to actions for the recovery of federal taxes or in Tax Court deficiency suits. *Wickwire* v. *Reinecke*, 275 U.S. 101, 105-106; *Phillips* v. *Commissioner*, 283 U.S. 589, 599, n. 9. See also *Glidden Co.* v. *Zdanok*, 370 U.S. 530, 572 (plurality opinion of Harlan, J.). Thus, although taxpayers can request a jury trial in a tax refund suit in the district court, it is a statutory and not a constitutional right. See 28 U.S.C. 2402.[2]

Damsky v. *Zavatt*, 289 F. 2d 46, 53-54 (C.A. 2), relied on by petitioner (Pet. 7-9), is distinguishable. There, the court held that a jury trial was guaranteed in a tax collection action brought by the government, because of its similarity to a common-law action of debt. However, the absence of such a guarantee in a Tax Court action was recognized. Thus, contrary to petitioner's argument (Pet. 7-8), there is no conflict with *Olshausen* v. *Commissioner*, 273 F. 2d 23 (C.A. 9). That case, a Tax Court deficiency action, in fact supports the decision below.

Petitioner further contends (Pet. 9-10, 12) that the discovery procedures in Tax Court actions are not as extensive as in district court suits; that less affluent taxpayers must choose the Tax Court if they are not able to pay the full tax; and that such disparate treatment violates their constitutional

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[2]Prior to the enactment of 28 U.S.C. 2402, it had long been settled that there existed no right to a jury trial in suits against the United States, since they are not "suits at common law." *E.g.*, *McElrath* v. *United States*, 102 U.S. 426, 439-440. Jury trials are not provided in tax refund suits in the Court of Claims.

rights. The requirement that a taxpayer pay the full amount of tax claimed to be due before he may litigate the correctness of the deficiency in a federal district court was established by this Court in *Flora* v. *United States*, 362 U.S. 145. Moreover, this Court has rejected the premise upon which petitioner's contention is based, *viz.*, that the Constitution requires that the review procedures in the Tax Court must be substantially identical to those in the district courts. See *Phillips* v. *Commissioner*, *supra*, 283 U.S. at 599-600.

2. Petitioner also argues (Pet. 10-12) that the nature of the Commissioner's deficiency determination further served to prevent him from paying the full amount of the deficiency and litigating the controversy in a federal district court refund suit. Specifically, petitioner reported substantial long-term capital gain from the transactions under scrutiny and claimed interest deductions. In his notice of deficiency, the Commissioner determined that the transactions were a sham and disallowed the interest deductions. At trial the Commissioner conceded that if his determination with respect to the interest deductions were upheld, the additional income as reported by petitioner would not have been taxable.

The Commissioner made these inconsistent initial determinations in order to perform his well-acknowledged duty to protect the revenue. Without taking such protective action, the Commissioner would have risked the possibility that petitioner's claimed interest deductions would have been allowed without the inclusion of the income which petitioner himself reported. As the Ninth Circuit stated under similar

circumstances in *Revell, Inc.* v. *Riddell,* 273 F. 2d 649, 660 (C.A. 9), certiorari denied, 364 U.S. 835, "We find no legal or logical reason which compels the Commissioner to run such risk in the proper performance of his duty to protect the revenue." See also *Commissioner* v. *Southwest Expl. Co.,* 350 U.S. 308, 309, n. 1; *Estate of Goodall* v. *Commissioner,* 391 F. 2d 775, 782 (C.A. 8), certiorari denied *sub nom. Goodall Electric Mfg. Co.* v. *Commissioner,* 393 U.S. 829; *Malat* v. *Commissioner,* 302 F. 2d 700, 704 (C.A. 9).

3. Finally, petitioner urges (Pet. 12-15) that interest deductions have been allowed to similarly situated taxpayers, in violation of his Fifth Amendment rights. Prior to trial, petitioner sought to discover every document, record, directive and inter-office memorandum in the files of the Internal Revenue Service relating to all taxpayers who ever paid interest to a lender on a loan secured by United States Government securities and whose interest deductions were questioned by the Service. Petitioner proposed to show unequal treatment. But as the court of appeals pointed out (Pet. App. A-2), the Tax Court correctly quashed the subpoenas because they were too broad and sought information which would unlawfully invade the privacy of other taxpayers.[3] In any event, the multitude of cases involving other taxpayers claiming similar interest deductions (see Pet. App. B-18 to B-20) refutes petitioner's claim of discrimination.

Contrary to petitioner's argument (Pet. 14) the Freedom of Information Act (5 U.S.C. 552) is not

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[3]See Section 7213(a)(1) of the Internal Revenue Code.

relevant. That Act became effective in 1967, after the Tax Court ruling, and taxpayer has never brought a separate district court action seeking relief under the Act.[4]

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General.

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[4]Even under the Freedom of Information Act, much of what petitioner sought to discover is protected from disclosure. 5 U.S.C. 552(b)(3). Cf. Sections 6103 and 7213(a)(1) of the Code and the Regulations thereunder.